



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

August 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 16-17 August 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 18 August 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 23 June, as reflected in the updated forecast published in *Monetary Bulletin 2010/3* on 18 August.

Financial markets

The average trade-weighted value of the króna in the onshore market was 2.6% higher at the time of the August MPC meeting than at its June meeting. Between meetings, the króna appreciated by 2.2% against the euro, 0.8% against the pound sterling, and 7.1% 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 been extremely low during the summer holiday season, amounting to 8 m. euros since the June meeting.

Since the last MPC meeting, residents' FX account balances in domestic banks have declined, due to the appreciation of the króna and debt restructuring measures within the banks.

In the offshore market, trading volume picked up over the summer and the appreciation that had begun in early June continued. The króna has traded at 215-220 against the euro since mid-July.

Risk premia for the Republic of Iceland, as measured by the CDS spread, has been broadly stable since the June meeting. The CDS spread fell below 300 basis points before rising again following international developments. The CDS spread for the sovereign was 320 basis points at the August meeting, compared to 327 basis points at the June meeting. The results of the Central Bank's buy back in June of government bonds expiring in 2011 and 2012 implied a cash-market risk premium of 570 basis points on these bonds.

About 73 b.kr. worth of certificates of deposit (CDs) were outstanding as of the August meeting, compared to 101 b.kr. at the June meeting.

Overnight interbank market rates were 0.5 percentage points above the current account rate as of the August meeting. Trading volume in the interbank market has been steady at 52 b.kr. since the last MPC meeting, concentrated in overnight transactions.

The yield in the mid-August Treasury bill auction was 4.68%, compared with 5.49% in the mid-July auction and 5.95% in the June auction. The yield on long Treasury bonds had declined by 0.26-0.09 percentage points since the June meeting. At the same time, yields on indexed HFF bonds had gone up by 0.05-0.1 percentage points, except for the shortest bond, which declined by 0.08 percentage points from the June meeting.

Preliminary figures on the banking system show that total assets of deposit money banks amounted to roughly 2,959 b.kr. at the end of May. Lending to residents amounted to 1,717 b.kr., including nearly 503 b.kr. to households and 1,091 b.kr. to companies. Total liabilities amounted to 2,577 b.kr., including almost 1,503 b.kr. in deposits held by residents.

The lending position to residents has decreased by almost 1% from March, due primarily to a 1.2% decrease in lending to companies. Foreign currency-denominated loans have declined by 3.2%, mainly due to the appreciation of the króna. Non-indexed loans have risen by 6.5%, in part due to restructuring measures involving conversion of foreign currency-denominated loans to domestic currency loans. Even though these figures should be interpreted with caution, as they are preliminary and are strongly affected by the restructuring of the banking system, they do indicate that credit growth is limited or non-existent. This suggestion is supported by money supply figures, with broad money (M3) contracting by nearly 5% from year-end 2009 to end-May 2010 – mainly due to a decline in domestic FX accounts.

Since the announcement of the MPC decision on 23 June, the change in the monetary stance as measured by the real interest rate depends on the measure of inflation and inflation expectations. In terms of current inflation and the Central Bank inflation forecast for the next six months published in the 18 August *Monetary Bulletin*, the level of restraint had increased markedly, or by around 2.5 percentage points, but in terms of one-year ahead inflation expectations (for households, firms and the bond market) it

remained unchanged. This was also broadly true for the risk-adjusted short-term interest rate differential with main trading partners.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in July, global growth is expected to reach 4.5% in 2010, which is 0.5 percentage points higher than in the IMF forecast published in April 2010. Furthermore, the forecast for world trade continues to be revised upwards, and the IMF now expects trade to grow by 9% this year, 2 percentage points more than in its April forecast. The latest OECD forecast, published in May 2010, projects 10.6% growth in world trade this year. The IMF forecast for economic growth and world trade in 2011 is unchanged.

Iceland's merchandise trade surplus was 8.7 b.kr. in June, somewhat below the average for 2010. The trade surplus measured 35 b.kr. in Q2/2010, increasing by 9% quarter-on-quarter. According to preliminary numbers, the trade surplus fell to 4.5 b.kr., although the trade balance was positive for the first time in July since 1995.

The króna value of exports increased by 28% year-on-year in June, led by a 55% rise in the export value of aluminium. According to preliminary data, exports continued to increase in July and were 16% higher than a year ago. The króna value of imports rose by 23% year-on-year in June, as the value of imports in all categories increased, with the strongest increase coming from imports of capital goods, which rose by 50% year-on-year. According to preliminary figures, króna import values grew by 4% year-on-year in July, with increases recorded in most major components apart from consumer goods.

The price of aluminium had risen since the time of the June MPC meeting and, at the beginning of August, was 12% higher than in June. The value of marine product exports had also been on the rise, increasing by 1.5% month-on-month in June.

The domestic real economy and inflation

The labour market survey conducted by Statistics Iceland in Q2/2010 indicated that the labour market has already begun to recover. Demand for labour increased on all measures in Q2/2010, for the first time since 2007. Employed persons as a share of the population aged 16-74 rose by 1.6 percentage points year-on-year, and total hours worked rose by 1.1% due to an increase in hours worked and the number of persons at work. The increase was most prominent in the oldest and youngest age groups, whereas the core age group (25-54 years) saw a decrease.

Registered unemployment was 7.6% in June and 7.5% in July, down from 8.3% in May and 9.3% in March. Seasonally adjusted unemployment has remained broadly stable at around 8% since April, but inched upwards to 8.3% in July.

The wage index rose by 2.2% month-on-month in June, due to a contractual wage increase taking effect on 1 June in the labour market as a whole. Nominal wages rose by 6.1% year-on-year. As a result of this wage increase and the 0.3% decrease in the CPI in June, real wages rose for the first time since January 2008, by 2.6% month-on-month and 0.3% year-on-year.

Indicators of demand differ as to where private consumption is heading. Payment card turnover and retail sales suggest that private consumption continued to shrink in Q2/2010. On the other hand, consumer goods imports have been growing. Furthermore, consumer expectations appear to have improved over the summer, and quarterly results from a June survey of expected purchases of real estate, motor vehicles, and travel showed an increase in households' expected purchases, mostly of motor vehicles.

The consumer sentiment index has continued to increase in recent months, rising to a post-crisis peak in July. Moreover, the sub-index measuring expectations toward the economic situation six months ahead exceeded 100 points for the first time since May 2008, indicating that more respondents were positive regarding the future economic situation than negative.

Statistics Iceland's nationwide housing price index, published in July, declined by 0.5% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, fell by 0.7% in June and by 0.4% adjusted to seasonality. Activity in the real estate market has picked up somewhat. Accumulated turnover in June was about 19% higher than in June 2009, although turnover remains very low in a historical context.

In Capacent Gallup's June survey among households, inflation expectations were unchanged since April, at 8%. On the other hand, household expectations of twelve-month inflation two years ahead had risen to 7% in June, as opposed to 6.5% in the last survey.

Inflation has abated rapidly since the MPC's June meeting. The consumer price index (CPI) fell by 0.66% in July, following a 0.33% decline in June. Twelve-month inflation measured 4.8% in July, and 4% excluding indirect tax effects. Seasonally adjusted, the CPI fell by 0.58% in the last three months, which is a 2.3% decline on an annual basis.

The decline in the CPI in June was due mainly to a 5.9% decrease in petrol and oil prices owing to a temporary price war between oil companies. Price decreases of domestic food and beverages also had a strong effect on the CPI in June, while prices of various other domestic items, such as private services, increased by 0.7% in June. Base effects played a significant part, as the June 2009 rise in the CPI of 1.4% disappeared from twelve-month measurements. The main factor contributing to the July decline in the CPI was stronger-than-expected summer sales. The effect on the CPI was -0.68 percentage points, well in excess of the five-year average of -0.46 percentage points. Exchange rate pass-through due to the strengthening of the króna has emerged slowly in recent months, mostly in prices of groceries and petrol. The housing component increased by 0.4% in June but declined by 0.02% month-on-month in July.

The updated forecast, published in the 18 August issue of *Monetary Bulletin*, assumes that this year's contraction in GDP will be 1.9% in 2010, roughly half a percentage point less than was projected in May. GDP is forecasted to return to year-on-year growth in Q3/2010, for the first time since Q2/2008. The improved outlook is attributable in large part to a smaller contraction in investment than previously assumed, in spite of further delays in energy-intensive industrial investment.

The contraction in domestic demand is estimated to be about one percentage point less in 2010 than was forecast in May, and because of the negative contribution from

external trade, the contraction in GDP will be greater than it would otherwise have been.

On the other hand, the GDP growth outlook for the next two years has deteriorated slightly since May. Output is now expected to grow by 2.4% for 2011, instead of the 3.4% forecast in May, and to grow by 1.7% in 2012, as compared to 1.9% according to the May forecast. These changes are due largely to less growth in domestic demand in 2011 and weaker exports in 2012, the latter of which is due to delays in industrial investment projects.

Private consumption growth is expected to be around half a percentage point weaker in 2010 than was assumed in the May forecast. This is in line with high-frequency indicators of private consumption developments, although these indicators are not unambiguous. The forecast for the next two years, however, is broadly in line with the May forecast.

Indicators imply that general business investment has begun recovering. Imports of investment goods increased significantly in Q2/2010, after contracting without interruption since 2006. The updated forecast assumes that general business investment will grow by about 15% in 2010, while the last forecast suggested a rise of only 8.4%. The outlook for general business investment in 2011, however, is similar to that in the May forecast, and business investment as a share of GDP is expected to have risen to its long-term average level by the end of the forecast horizon.

Because of stronger business investment and a smaller contraction in residential and public investment, gross capital formation is estimated to shrink by just under 4% this year, whereas the May forecast assumed a contraction of over 10%. The outlook for general investment in 2011 is broadly unchanged from the May forecast, while stronger growth is projected for 2012, with a greater share of energy-intensive investment shifting to that year.

Developments in public consumption are expected to be similar to the last forecast. Public consumption will contract by about 2½-3½% per year during the forecast horizon, and public expenditure will contract until 2012. It is assumed that public sector finances will be broadly in line with the May forecast, and in line with the economic programme.

According to the August forecast, labour demand will not increase year-on-year until mid-2011, although there are indications of a turnaround in the labour market already. The employment rate, however, will be just over half a percentage point higher in 2010 than was forecast in May. Furthermore, unemployment is expected to be about one percentage point lower throughout the forecast horizon than in the May forecast, peaking at 9% in Q1/2011 before gradually tapering off as the economy recovers and falling to about 6% in 2012.

Wage growth is projected to be similar to the last forecast; however, the larger-than-expected growth in the labour force implies that productivity will be somewhat lower this year than was previously assumed. As a result, unit labour costs will increase by about 6% this year, one percentage point more than was forecast in May. Developments of the next two years, however, are expected to be in line with the May forecast.

Since the publication of the May issue of *Monetary Bulletin*, the króna has strengthened by about 8% in trade-weighted terms. According to the updated forecast, the exchange

rate will remain near current levels throughout the forecast horizon, just over 7% stronger against the euro than was forecast in May.

The measured current account deficit for 2010 is projected to be somewhat larger than in the last forecast. The trade surplus will be slightly less than in the previous forecast, or 9.6% of GDP in 2010, largely due to a stronger contraction in marine product export production than previously expected. The forecast assumes as well that the deficit in the balance on income will be larger than previously projected, as revised figures for 2009 revealed a wider deficit than previous figures suggested. The underlying current account surplus for 2010 (the current account surplus less accrued interest due to credit institutions in winding-up proceedings) will be slightly smaller, however, than in the last forecast. It is assumed that the measured current account deficit will rise again temporarily in 2011, and that the underlying surplus will narrow, in line with the May forecast.

The outlook is for inflation to subside more rapidly this year than was assumed in the May issue of *Monetary Bulletin*. This is attributable to a considerably stronger exchange rate and lower inflation expectations, among other factors. In addition, summer sales effects proved stronger than in recent years but it is uncertain whether these effects will reverse in full when new goods are purchased at a stronger exchange rate. Headline inflation is projected to reach the Central Bank's inflation target in the second quarter of 2011, while inflation excluding consumer tax effects is expected to reach the target at year-end 2010, somewhat earlier than in the May forecast.

The outlook is for a slightly smaller output slack early in the forecast horizon than was projected in May, or 4% instead of 4½% in 2010. As was forecast in May, the slack will narrow gradually and will almost disappear by the end of the forecast period.

II The interest rate decision

The Governor informed the MPC of the status of the Third Review of the IMF Stand-By Arrangement, associated funding and the outlook for reserves, the status of the dispute over compensation to depositors in foreign branches of Landsbanki, and the recent meeting with the executive board of the Confederation of Icelandic Employers (SA). The MPC was also informed of the work currently underway relating to the effect on financial stability of the Supreme Court rulings on the legality of exchange rate-linked loans and the agreement on financial stability recently signed by the Nordic and Baltic governmental ministries, central banks and supervisory authorities.

The Committee observed that inflation had declined markedly in recent months. Twelve-month inflation fell from 7.5% in May to 4.8% in July, or 4% excluding consumption tax effects. This is more rapid disinflation than in the Central Bank's May forecast, due in large part to a stronger-than-expected exchange rate. According to the updated inflation forecast, published in the *Monetary Bulletin* 2010/3 on 18 August, inflation excluding tax effects will reach the Bank's inflation target by year-end and fall somewhat below target early in 2011. Inflation expectations had also declined sharply in the recent term.

The Committee noted that the króna had appreciated by over 2½% in trade-weighted terms since the MPC's last meeting, held in June, and by over 2% against the euro,

without any foreign exchange market intervention by the Central Bank. Furthermore, over the same period, the CDS spread on sovereign debt had remained broadly unchanged. The capital controls, developments in terms of trade and the current account balance, and the interest rate differential with major currencies all continue to support the exchange rate.

The Committee discussed the change in the monetary stance from the June meeting. It agreed that given the inflation outlook, the Central Bank's interest rates were rather high, and that there were scope for continuing to lower them. Declining inflation and inflation expectations had caused real Central Bank interest rates to rise since the last interest rate decision date. Furthermore, although recovery appears to be underway, it is still weak at present, and the outlook is for a significant output slack for the next few years. The MPC saw that lower inflation, lower inflation expectations, a stronger króna, and the prospect of more rapid disinflation than previously expected provided the scope for a larger interest rate reduction than had generally been justifiable in the past year.

In the Committee's view, other factors called for more cautious steps, however. It is not yet clear to what extent the recent disinflation episode reflects short-term factors.

Furthermore, the MPC stressed the need to take into account that when capital account liberalisation begins, the risk-weighted interest rate differential between Iceland and abroad must provide sufficient support to the króna. In the MPC's view, there is still some uncertainty about when it will be possible to begin lifting the capital controls. Consequently, it is difficult to state what this entails for interest rate policy over the next few months.

Members discussed the possibility of lowering the policy rate by 0.5 to 1.5 percentage points. In light of the discussions, the Governor proposed a rate cut of one percentage point, which would lower the deposit rate (current account rate) and the CD rate to 5.5% and 6.75%, respectively, the seven-day collateral lending rate to 7.0%, and the overnight lending rate to 8.5%. The Committee voted unanimously in favour of the Governor's proposal.

The MPC discussed the strategy for relaxing capital controls. When the Third Review of the Government-IMF economic programme is complete, the preconditions for capital account liberalisation will be in place as regards the foreign exchange reserves and macroeconomic stability. However, there is still considerable uncertainty about the strength of the financial system in the wake of the recent Supreme Court judgments. The Committee therefore judged it necessary to review the existing capital account liberalisation strategy in view of changed circumstances and the delays that have already occurred.

The Committee also discussed the Bank's foreign reserves level and its composition and the need to replace the Central Bank's borrowed foreign exchange reserves with non-borrowed reserves. In the Committee's view, the appreciation of the króna and the decline in risk premia on Icelandic financial obligations provide the scope for modest foreign currency purchases for this purpose; consequently, it was decided to begin FX purchases on 31 August. The quantity and implementation will be decided with the aim of minimising the impact on the króna.

As before, the Committee agreed that the premises for continued monetary easing should be in place, provided that the króna remains stable or appreciates and inflation

subsidies as forecast. Furthermore, the MPC agreed that it 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 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, 22 September 2010.