Minutes of the Monetary Policy Committee meeting, March 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 March 17 and 18, 2009, during which the Committee discussed economic developments, the policy rate decision of March 19, and the communication of that decision.

I Economic and monetary developments

During its discussions, the MPC placed emphasis on the following new information that has emerged since the previous interest rate decision on January 29:

Financial markets and the Central Bank of Iceland balance sheet

The effect of a change in the Central Bank's policy rate on the economy is uncertain and probably limited.

The restructuring of the banking sector has proceeded more slowly than was anticipated in January.

Improvements have been made in the liquidity management of the Central Bank, and the IMF criteria for net reserves and liquidity creation are being met.

On December 17, the Central Bank announced measures designed to stimulate interbank market activity. It was decided to widen the corridor between the highest and lowest interest rates on the banks' current accounts with the Central Bank. Trading volume in the interbank market rose immediately afterwards but has fallen again since. Trading volume averaged ISK 2.9 billion in January and ISK 1.8 billion in February, and has totalled ISK 410 million so far in March.

While the data on lending to companies are still limited, the available data indicate that credit creation by deposit money banks (DMBs) is largely non-existent. Deposits with DMBs increased by roughly ISK 250 billion from August to December, due in part to closures of mutual and investment funds (which explains at least ISK 112.5 billion). Pension fund deposits increased by ISK 66 billion. At the same time, however, the possibility of double counting must be kept in mind because a portion of the increase in pension fund deposits is due to investment fund closure.

The króna has been depreciating recently, after appreciating at the beginning of the year. On average, the trade-weighted exchange rate index (TWI) was 18% higher in the second week of March than in the second week of January.

Short-term interest rates in the rest of the world have declined significantly since the monetary policy decision in January, widening the interest rate differential between the króna and other currencies. In mid-March, the three-month interbank interest rate differential against the euro averaged 16.5%, roughly half a percentage point higher than in January. However, this large interest rate differential may partly reflect a high risk premium on Icelandic assets.

There is still considerable uncertainty about the supply of domestic government-guaranteed bonds, and this uncertainty has affected the yields on both nominal and indexed Government-guaranteed bonds.

Yields on long-term indexed bonds have risen and were, on average, 0.3-1.0 percentage points higher in the first two weeks of March than they were in January. The rise is partly explained by reduced demand for HFF bonds, which stems from uncertainty about a temporary statutory amendment permitting pension fund members to withdraw up to ISK one million from Pillar 3 voluntary pension schemes in 2009 and 2010. Lower inflation expectations, a higher risk of deflation and uncertainty about future political actions, such as debt write-off and the magnitude and financing of the credit portfolios transferred to HFF from the commercial banks, have also been affecting yields.

On average, yields on nominal Treasury bonds were 0.2-0.7 percentage points lower during the first two weeks of March than in January, due to expectations of a policy rate reduction and increased demand from foreign investors for the shortest maturities. Forward interest rates implied expectations of a roughly one percentage point interest rate cut at the March meeting, while market participants expected a 0.5-1.5 percentage point cut.

On average, inflation expectations implied by yield spreads between nominal and inflation-indexed government bonds were 3.5 percentage points lower during the first two weeks of March than in January. It is not clear to what extent this is caused by mispricing in the market or improved anchoring of inflation expectations.

Outlook for the global real economy and international trade

The global financial crisis has deepened since the January interest rate decision. Global economic activity is falling, and total output in the advanced economies fell sharply in the fourth quarter of 2008. Consumer price inflation abroad is low, global commodity prices have been falling, and inflation expectations have been on the decline. Key policy rates have been cut aggressively and are approaching zero in many countries. Some central banks have already adopted alternative monetary policy measures, and governments have been implementing a wide range of policy actions in order to stimulate demand and improve the condition and functioning of the financial system.

Growth prospects for Iceland's main business partners have deteriorated. According to *Consensus Forecasts*, output is now projected to contract by 2.6% in 2009, down by 1¾ percentage points from January. In 2010 a gradual recovery is forecast, with growth projected at ¾%.

The outlook for the domestic export sector has deteriorated, as global demand is weaker than was forecast in January. This will have implications for export-driven growth and the overall terms of trade. The negative impact is appearing in lower prices of the main export products. There are also signs of reductions in export volumes, but this may be temporary, as production in the export sector does not appear to be slowing down.

Despite continuing cutbacks in global aluminium production, aluminium prices are projected to be about 8% lower in 2009 than anticipated in January. The nominal value of exported aluminium contracted sharply month-on-month in January, due to lower prices and smaller quantities. The preliminary figures for February tell the same story, even though the competitive advantage of Icelandic producers supports high Icelandic production levels.

New data for the marine sector show that the January forecast was too optimistic. Fish prices fell by about 4% month-on-month in January and have continued to fall in February and March, according to sales personnel. On the other hand, figures for service exports, especially tourism, have been revised upwards for 2009.

The trade balance on goods and services turned into a surplus in the fourth quarter of 2008, and this trend is expected to continue. Underlying trade flows should therefore support the króna over the medium term.

The domestic real economy and inflation

Preliminary quarterly national accounts figures for the Icelandic economy show that the economy was cooling somewhat faster in the latter part of 2008 than the January forecast assumed. In real terms, GDP declined by 1.5% year-on-year in Q4 2008, a contraction similar to that in Q3. For the year as a whole, the preliminary figures show slightly positive GDP growth measuring 0.3%.

Q4 2008 saw a positive change in the balance of trade, due to an almost 50% contraction in imports year-on-year. In 2008, imports fell 18% while exports rose by roughly 7%. Exports of goods increased by about 11%, but service exports fell by 1.3%. The positive contribution of net trade more than offset a 9% contraction in domestic final expenditure, making the growth rate of GDP slightly positive for 2008 as previously mentioned.

While the trade balance turned positive in the fourth quarter of 2008, the current account deficit was considerably larger than in the preceding quarter, due to an extremely large deficit on the income account. In the fourth quarter of 2008, the current account deficit equalled 50% of that quarter's GDP. For the year as a whole, the current account deficit totalled 34% of GDP, compared with a current account deficit of 16% of GDP in 2007. Due to a large negative balance on primary income from abroad, the reduction in gross national income was large, almost 30%.

So far this year, the contraction in demand, as reflected in payment card and groceries turnover and numbers on imported investment goods, is escalating and remains in line with the January forecast. Domestic payment card turnover of individuals contracted by more than 25% in real terms. This follows a contraction of over 20% in the fourth quarter of 2008. From November 2008 to January 2009, expenditure on imported investment goods contracted by 70% compared to the same period a year before.

The 2008 fiscal position came out weaker than expected in January because of lower tax revenue. Public consumption increased by 2.8% instead of 3.5%, and public investment was substantially lower than previously assumed, 1.6% instead of 10.6%.

New labour market figures are in line with the January forecast. Registered unemployment rose from 6.6% in January to 8.2% in February, far above its natural rate. Seasonally adjusted unemployment was 6.7% in February. Since measurements were introduced, unemployment has never been this high or risen this fast.

Real wages were down by 9.4% in January, and in Q4 2008, nominal wages in the private sector fell for the first time, by ½% from the previous quarter.

Preliminary numbers indicate that there were about 10% fewer foreign workers at the end of last year than at mid-year.

The negotiated wage increases that were to take effect in March 2009 have been postponed until July 2009.

The rapid rise in unemployment indicates that a negative output gap has already emerged, one quarter earlier than assumed in January.

Inflationary pressures are disappearing and the inflation outlook is improving somewhat faster than was forecast in January. Headline inflation measured 17.6% in February, down from 18.6% a month earlier. Core inflation may also have peaked in January at 18.5%, as it measured just over 18% in February. Three-month seasonally adjusted annualised inflation was 13% in February, down from almost 19% in January.

The exchange rate pass-through from last year's depreciation appears nearly complete, reflecting the flexibility of the Icelandic economy.

In February, real house prices fell by nearly one-fifth year-on-year, while nominal prices declined by just over 5%.

Simple cost-push models suggest that the CPI will decline by 0.6% in March. Updated forecasts project inflation at 17.5% in Q1 2009 and 12.4% in Q2, one to two percentage points lower than forecast in January. The exchange rate has strengthened somewhat more than expected in the first quarter.

The updated forecast indicates slightly weaker activity during the forecast horizon. National expenditure is expected to be lower in 2009-2012. The contraction in investments will be more pronounced in 2009-2011, partly because of the postponement of the Helguvík aluminium project. There has also been a downward revision of government spending and investment. Imports are projected to fall further and exports are projected to rise in association with reduced demand and a weaker real exchange rate. Despite weaker domestic demand, a lower exchange rate is expected to ensure that the trade balance will keep GDP growth stronger in 2010 than forecast in January but in line with the forecast for the rest of the horizon.

According to the forecast, inflation will be close to the 2.5% target in 2010 instead of 1.5%, as was projected in January.

The outlook is therefore broadly in line with the January forecast: the real economy is adjusting rapidly, reflecting its flexibility. At the same time, inflationary pressures are disappearing quickly, and prices will remain stable as long as the exchange rate remains relatively stable.

II The interest rate decision

The MPC agreed that, while the long-term objective of monetary policy remains the inflation target, the interim objective was the stabilisation of the exchange rate. This was due to the fragility of the balance sheets of households, businesses and banks. Recently, there have been limited market pressures pushing the exchange rate in either direction. The MPC agreed that there were no compelling reasons to aim for an exchange rate level much different from the current one. However, some MPC members argued that although the króna could have reached a temporary equilibrium value from a short to medium-term perspective, the real effective exchange rate was still quite low from a long-term perspective.

The Committee discussed the importance of exchange rate stability in terms of private sector bank and non-bank balance sheets during the ongoing debt restructuring process. Due to unhedged foreign currency exposure, a significant depreciation would jeopardise the balance sheets of households and corporations, while a significant appreciation would weaken the capital base of the new commercial banks, which are long in foreign currency.

The main objective of the capital controls is to protect reserves from a disorderly outflow of non-resident and resident capital. The MPC decided that the conditions for lifting the capital controls were not yet in place, as the global environment remained difficult and there was uncertainty about the level of external debt, government financing, and financial sector restructuring. However, many of these issues are now being worked on, and further clarity is expected in the second quarter of this year.

The Committee agreed that economic indicators suggested that conditions for significant monetary policy easing were in place. The flexibility of the Icelandic economy had enabled a rapid adjustment of domestic demand, real wages and the trade balance.

The MPC observed that inflationary pressures were disappearing and the inflation outlook was improving rapidly, supported by the growing slack in the economy as indicated by national accounts data, higher unemployment and other short-term indicators. After a one-off adjustment following the depreciation of the króna through 2008, inflation appears to have peaked in January and seems to be declining somewhat faster than previously forecast.

All members agreed that a policy rate cut in the range of 0.5 to 1.5 percentage points would be appropriate in view of the possible negative impact of monetary policy easing on the stability of the króna.

Members preferring a relatively small cut argued that the easing cycle should begin with caution due to the great uncertainty concerning the currency market's reaction to an interest rate cut due to limited trading in the markets and the large stock of foreign-owned ISK financial assets. The members noted that, while there was some clarity about the macroeconomic situation, much was unknown about the effect of interest rate changes on exchange rates and the effect of exchange rate changes on private sector balance sheets.

The argument was made that monetary policy decisions should be taken with a view towards the eventual abolition of capital controls and that ISK-denominated assets must continue to offer sufficiently favourable risk-adjusted yields. There is, however, uncertainty about the size of the risk premium.

Furthermore, it was argued that the continued large uncertainty concerning external debt, government financing and financial sector restructuring, and the global environment must be taken into account. However, the members agreed that once financial sector restructuring is completed, the overall external and public debt situation and fiscal adjustment have been clarified, and financial markets have become more functional, the ability of monetary policy to support economic recovery over the medium term will be enhanced.

Although some members argued that it was important to keep a close eye on upcoming CPI numbers, others argued that the CPI numbers were only a reflection of the past exchange rate depreciation and that a cut at the higher end of the range of suggested policy rate changes might be more appropriate, pointing out that any fear of inflation was unwarranted and that the economy had responded remarkably in a short time. Interest rate differentials had also increased since January. The vitality of domestic businesses was also important for the stability of the currency, and the danger was that high interest rates were draining liquidity from businesses and gradually pushing them into insolvency.

The MPC agreed that a gradual approach was justified because of the uncertain relationship between interest rates and exchange rates and the fragility of the balance sheets of businesses, households and banks. It was also noted that the uncertainty surrounding the outlook was unusually pronounced. Therefore, the Committee decided to schedule an additional rate-setting meeting for April 8, 2009. At that meeting, the effects of the present decision could be assessed, and new inflation numbers would be available.

In view of the decision to schedule another meeting in three weeks' time, members agreed that the easing cycle should start with a relatively small step, and the Governor of the Central Bank of Iceland proposed that the policy rate be lowered to 17%.

The Governor invited other MPC members to vote on the proposal. And the MPC voted unanimously in favour.

The Committee agreed on the following interest rate announcement schedule for 2009 but maintained the option of scheduling additional meetings between September and December.

Interest rate announcements and publication dates for *Monetary Bulletin* in 2009		
Date of interest rate decision	*Commentary published in*	*Weeks since previous interest rate decision announcement*
January 29	*Monetary Bulletin* 2009/1 – forecast update	11
March 19	Press release	7
April 8	Press release	3
May 7	*Monetary Bulletin* 2009/2	4
June 4	Press release	4
July 2	Press release	4
August 13	*Monetary Bulletin* 2009/3 – forecast update	6
November 5	*Monetary Bulletin* 2009/4	Interim meetings may be scheduled at a later date

The Committee stressed that laying the foundation for a healthy financial system is an essential part of the effort to rebuild the economy. It argued that it is important that the "new" and "old" banks be restructured in a timely and appropriate fashion. The Committee also found it important that actions be taken by the banks with support from creditors, owners, and the authorities to strengthen the capital base. This process should be carried out so that the State does not absorb any further private sector losses from the banking crisis.