



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

## Minutes of the Monetary Policy Committee meeting

September 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 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 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 meetings held on September 22 and 23, 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of September 24, 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 economy and Iceland’s external trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the previous interest rate decision on August 13.

#### **Financial markets**

The króna has been relatively stable since the last MPC meeting, depreciating by 0.6%, compared to 1.8% depreciation during the month of July. At the same time, foreign exchange market intervention by the Central Bank of Iceland was much more limited than in previous months, especially in September. Turnover in the FX market increased in August after a slow July. Residents’ FX account balances at domestic banks have remained stable since the last MPC meeting, reducing pressure on the króna.

The króna exchange rate has been broadly stable in the offshore market and was trading at close to 215 against the euro at the time of the MPC meeting, after remaining in the 210-220 range since the previous meeting. Turnover in the offshore market has been slightly lower in September and August than over the preceding summer months.

The banking system has been highly liquid since the summer. Demand for collateralised loans at the Bank's lending facilities has been almost non-existent and trading in the interbank market has come to a standstill. The Central Bank's current account rate provides a floor for overnight interest rates on actual loans in the interbank market. Overnight REIBOR rates have fallen below this floor, but no transactions have been taking place at these rates.

Interest rates on Icelandic government bonds have been relatively stable since the last meeting. Treasury note auctions have been brisk, and the goal for the year of sales of 145 b.kr. was reached in August.

Risk premia on the Republic of Iceland, as measured by CDS spreads, have continued to fall, in line with a general decline in risk aversion in global markets. The decline has, however, been greater for Iceland. However, this data must be viewed with caution as limited trading may be taking place.

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

The merchandise trade balance was positive by 6.8 b.kr. in July. This is somewhat lower than in the two previous months, when the surplus amounted to 7.4 b.kr and 8.7 b.kr respectively. According to preliminary numbers, the August trade surplus was 12.5 b.kr.

The value of aluminium exports increased by 5% month-on-month in July, due to a 6% increase in aluminium prices. Aluminium prices continued to rise in the first half of August, peaking at levels not seen since November 2008, but have eased slightly since that time.

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

Preliminary quarterly national accounts figures from Statistics Iceland show that the Icelandic economy was somewhat stronger in Q2/2009 than assumed in the Central Bank's latest forecast, which appeared in *Monetary Bulletin* 2009/3 in August.

Real GDP fell by 6.5% year-on-year in Q2/2009, a larger decline than in Q1. This was mainly due to an 8.6% contraction in exports, which contrasts with 9% growth in Q1.

Private consumption fell by 17% year-on-year in Q2/2009, a smaller decline than in Q1/2009. Government consumption fell slightly after a small rise in Q1. Gross fixed capital formation, business sector investment and residential investment fell by 47%, 53% and 45%, respectively, year-on-year in Q2/2009. These declines were smaller than those in Q1. Government fixed investment fell by 30% year-on-year. Imports contracted by 35% year-on-year in Q2, about the same size contraction as in the previous quarter.

The current account deficit was 46 b.kr. in Q2/2009. Measured as a percentage of GDP, this is one percentage point lower than in Q1, or 12.4%. The deficit is due to a 69.4 b.kr deficit on the income account, which is mainly a result of interest payments related to the "old banks". Most of this interest is accrued, but has not been paid, and therefore does not result in actual payment outflows. Excluding this item, the income account deficit was 36 b.kr. and the current account deficit was 10 b.kr., or 2.8% of GDP. The service account, on the other hand, had a surplus of 7 b.kr. thanks to increased net income from transportation and substantially larger income from tourism. This is the

first time in 18 quarters that the service account has been positive. The merchandise trade account had a surplus of 18.4 b.kr in Q2.

Revised Q1/2009 national accounts figures show a larger year-on-year contraction for all subgroups than did the June figures, with the exception of government final consumption and government fixed investment. Year-on-year growth in exports in Q1/2009 was almost 2 percentage points less than earlier figures indicated, or 9%. This gives a GDP contraction of 4.5% year-on-year in Q1/2009, as opposed to 3.9% according to June figures.

According to the revised national accounts figures, the economy was noticeably stronger in 2008 than the preliminary figures from March had indicated. GDP growth was 1.3%, an increase of one percentage point over and above the March figures. The latest numbers are much more in line with the Central Bank's forecast before the initial release from Statistics Iceland. The main reason for this revision is a smaller contraction in gross fixed capital formation and a larger increase in government final consumption.

Unemployment has continued along the path it has followed since April. Seasonally adjusted unemployment has continued to rise, from 8.3% in April to 9.1% in August, while registered unemployment has continued to fall over the same period, by 1.4 percentage points to 7.7%.

The effect of negotiated wage increases in some sectors more than offset a drop in wages in other sectors. The low-wage focus of wage contracts largely explains wage increases in manufacturing and wholesale from Q3/2008 to Q2/2009, while wages in construction and financial intermediation have fallen. The results of wage renegotiations in June drove wage increases in July and August, when the wage index rose month-on-month by 0.4% and 0.02%. The year-on-year increase in the wage index was 2.2% in August, while real wages declined by 7.8%.

Since February, the decline in payment card turnover has slowed. The year-on-year contraction in real terms in domestic payment card turnover of individuals was 13% in July and August, after having contracted by 15% in Q2 and by almost one-fourth in Q1 from the same period a year before. The smaller contraction in July and August is explained primarily by a slower decline in debit card turnover, as the contraction in credit card turnover has increased slightly.

The index for residential housing prices in the greater Reykjavik area rose marginally month-on-month in July and August. This should not be interpreted as a shift in the housing market, as market turnover is very low, with housing swaps representing around 30-50% of transactions.

The consumer sentiment index and its sub-indices increased slightly in August. All measures have been relatively stable at historically low levels since the drop in sentiment in the wake of the outbreak of the financial crisis, with the exception of a few months earlier this year, when all indices except sentiment towards the current situation rose somewhat.

Annual inflation continued to decline in August. The CPI rose by 0.52% in August, bringing the twelve-month inflation rate down to 10.9%, from 11.3% in July. Annualised seasonally adjusted three-month inflation was slightly lower, or 10.1%.

The largest contributors to the August decline in twelve-month inflation are the housing component, prices of new motor vehicles, furniture, and furnishings, while the end-of-summer sales caused a 5.9% jump in clothing and footwear prices. The effect of the summer sales was 0.1 percentage point less than last year, or 0.43%.

Prices of new motor vehicles dropped by 4.4% from July as dealers attempted to dispose of older models. Prices of furniture and furnishing declined by 3.8% and owner-imputed rent fell by 0.8%. Twelve-month inflation excluding the housing component measured 16.1% in August.

In August, the CPI excluding tax effects measured 10%, the smallest twelve-month increase since April 2008, when the CPI was 8.7%. Underlying inflation measured by Core Index 3 excluding tax effects amounted to 12% in August.

Some exchange rate pass-through is still evident in the CPI. This was the main reason for the 1.1% increase in grocery prices in August. Prices of imported goods increased by 0.6% between months in August. Prices of imported goods have risen by almost 25% in the last twelve months.

## **II The interest rate decision**

The Governor informed the MPC of the status of the First Review of the IMF Stand-By Agreement (SBA) and the bilateral negotiations with the British and Dutch governments. The Committee emphasised the importance of the First Review of the SBA in restoring confidence and as a prerequisite for a successful liberalisation of the capital controls. The Committee also discussed other conditions that must be met prior to the phased removal of the capital controls, including continued Government commitment to a sustainable medium-term fiscal plan and well-advanced financial sector restructuring. The MPC was of the view that some progress had been made.

The MPC noted the goal of the social partners, the Government of Iceland and the National Association of Local Authorities, as seen in the Stability Pact, for creating conditions that would allow the policy rate of the Central Bank of Iceland to return to a single-digit figure by 1 November 2009. As discussed below, the Bank's deposit rate is currently the appropriate measure of the monetary policy stance. With this rate now at 9.5%, Committee members agreed that the monetary policy stance was already consistent with the premises of the stability pact.

The Committee discussed the signs of improvement that have emerged since the August meeting. Along with a lesser need for foreign exchange intervention, the trade surplus had turned out somewhat larger than expected. Furthermore, the business sector's accumulation of foreign exchange deposits at domestic banks had stopped, and export prices had firmed. Moreover, CDS spreads suggest that the risk premium on króna-denominated assets appears to have continued to decline.

The MPC discussed recent financial market developments. Among the issues covered were the ample liquidity in the domestic banking system, the extent of circumvention of the capital controls, the low trading volume in the onshore and offshore foreign exchange markets, the slope of the yield curve and the maturities and issuances of government debt.

The Committee noted that the króna had remained broadly stable since the last monetary policy decision on August 13, in spite of significantly reduced Central Bank intervention in the FX market, and that market turnover had increased somewhat.

MPC members indicated their unease over the extent of possible circumvention of the capital controls, which has been a continuing cause for concern and may have contributed to the persistent weakness of the króna. The Committee welcomed the Central Bank's recent adoption of important measures to strengthen surveillance and enforcement of the controls. In addition, MPC members stressed the importance of providing sufficient returns on króna assets to provide support for the currency.

The Committee discussed the inflation outlook. Although the króna had stabilised recently, it remained weak, with negative consequences for disinflation. Although all members expected inflation to resume a strong downward trend later this year due to the slack in the economy, reducing the risk of significant second-round effects, some members argued that the deteriorated inflation prospects had implications for the monetary policy decision.

The MPC discussed the monetary policy stance since its last decision. Since April 2009, the Bank's refinancing rate, i.e. the seven-day lending rate at 12.0%, has had little importance in affecting market interest rates as the ample liquidity in the system has meant that little borrowing from the Bank is taking place. A more appropriate measure of the policy stance has therefore been the Bank's deposit rate of 9.5%. But even at this rate, the Committee saw signs of excess liquidity in the system with short-term market rates and retail rates falling significantly below that rate. The Committee therefore agreed that the monetary stance had been more lax than the MPC intended with its last decision. To absorb this excess liquidity, the Committee agreed to auction off 28-day certificates of deposit (CDs), with set minimum and maximum bid rates and with a maximum amount sold in each auction.

The Committee agreed that while conditions in the real economy supported further easing of monetary policy, the prevailing fragility of the balance sheets of households, businesses, and banks, called for a firm focus on exchange rate stability while these balance sheets are restructured and rebuilt. This would call for a tighter monetary policy than would otherwise be necessary.

The MPC discussed various ways of structuring the interest rates on the CDs as well as the overall monetary policy stance. It discussed bid rates for the CDs between a minimum of 9.5% and a maximum of 10.5% and a deposit rate ranging from 8.0% to 9.5%. The Committee also discussed whether to leave its interest rate on collateralised seven-day loans unchanged or to lowering it to 11.0% and whether or not to cut the overnight lending rate from 16.0% to 14.0%.

The Committee discussed the varying perceptions among economic agents of what the true measure of the monetary policy stance currently is. The Government, the wage-setters, and the media seem to view the Bank's collateralised lending rate as the true measure of the policy stance, while most market participants understand that the Bank's deposit rate is currently a better measure of the true stance.

In light of the discussion, the Governor proposed that the collateralised lending rate be cut by 50 basis points to 11.5%, the deposit rate lowered by 25 basis points to 9.25%, and the overnight lending rate lowered by 150 basis points to 14.5%. Furthermore, he

proposed that the 28-day CDs be auctioned with a minimum bid rate of 9.5% and a maximum of 10%. The Governor pointed out that this proposal would leave the overall monetary policy stance unchanged, although its composition might be different. Even if the collateral loan and deposit rates were cut, the effective rate would still be 9.5% because of the auction of CDs with a minimum bid rate of 9.5%.

All members were in favour of the Governor's proposals to lower the overnight lending rate by 150 basis points and to auction 28-day CDs with a bid rate ranging between 9.5% and 10.0%. Two members voted in favour of lowering the collateralised lending rate by 50 basis points and the deposit rate by 25 basis points. Three members voted against this proposal, favouring unchanged collateralised lending and deposit rates.

Those in favour of lowering the deposit rate argued that it would facilitate the auctioning of CDs and might thus end up draining more liquidity from the market. As for the signalling effect of lowering the collateral lending rate, it was argued that this would help communicate that the effective policy rate was currently well below 12.0% and that given current prospects there was no near term need to raise it back to that level. It was argued that even though inflation prospects must be borne in mind the risk of second-round effects from the weak currency was very limited given the slack in the economy, and that prospects for a significant decline in the inflation rate in the next few quarters were still in place.

A majority of Committee members, however, wanted to keep the collateralised lending rate and the deposit rate unchanged. Favouring caution, they stated that it was necessary to see more issues resolved before lowering these rates. They maintained that the current objective of monetary policy was to stabilise the exchange rate and that recent exchange rate developments were not sufficiently favourable to justify cutting rates. Moreover, they found it important to demonstrate a commitment to stabilise the exchange rate.

One member was also concerned that even though the collateralised lending rate is not playing an important role at the moment, it is likely to resume its importance as the key determinant of the marginal cost of short-term financing once liquidity had returned to a more normal level. Lowering this rate now could lead to lower longer-term bond rates through the expectations of lower future short rates and thus reflect an easing of the policy stance.

The Monetary Policy Committee thus decided to keep the collateral loan and deposit rates unchanged at 12.0% and 9.5% respectively, but to cut the overnight lending rate from 16.0% to 14.5%. Furthermore, it decided to auction 28-day certificates of deposit with a minimum bid rate of 9.5% and a maximum of 10.0%.

The following members of the Committee were present:

Már Guðmundsson, 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, November 5, 2009.