MONETARY POLICY COMMITTEE REPORT TO ALTHINGI

2010 • 2

Monetary Policy Committee report to Althingi

22 December 2010

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee of the Central Bank of Iceland shall submit to Parliament a report on its activities twice a year and that the contents of the report shall be discussed at a joint meeting of the Economics and Tax Committee, the Budget Committee, and the Commerce Committee.

The Act requires that the Monetary Policy Committee meet at least eight times each year. Since the Committee began its work on 26 February 2009, it has met seventeen times, including three meetings since it last sent a report to Parliament. The following report discusses the work of the Committee between September and December 2010.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal objective of the Monetary Policy Committee is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2.5%. In implementing monetary policy, the Monetary Policy Committee bases its decisions in part on an appraisal of economic affairs and the outlook for the national economy as it is presented in the Bank's *Monetary Bulletin*.

Since the financial and currency crisis struck Iceland so forcefully in 2008, the Monetary Policy Committee's main task has been to promote exchange rate stability in accordance with the joint economic policy agreed by the Government, the Central Bank, and the International Monetary Fund. Among the goals of that policy has been to protect private sector balance sheets from further shock during the economic restructuring and rebuilding phase. A stable exchange rate also contributes toward bringing inflation into line with the inflation target. As economic structuring progresses, however, the inflation outlook has regained its importance in monetary policy decisions. The MPC's statements and minutes, enclosed with this report, contain the grounds for the Committee's decisions.

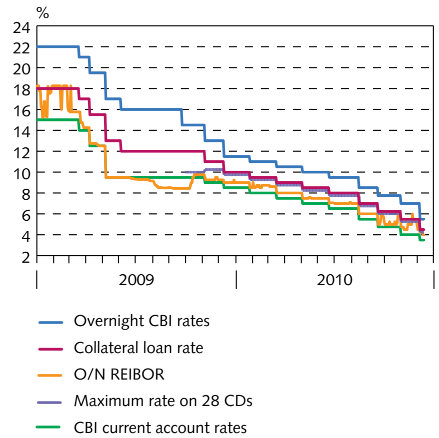
Table 1. Central Bank of Iceland interest rates 2010 (%)

Date	*Current account*	*28-day CDs (maximum)*	*7-day collateral lending rate*	*Overnight lending rate*
8 Dec	3.50	4.25	4.50	5.50
3 Nov	4.00	5.25	5.50	7.00
22 Sep	4.75	6.00	6.25	7.75

Chart 1

Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2009 - 15 December 2010

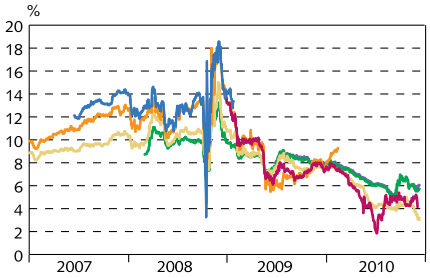


Source: Central Bank of Iceland.

Chart 2

Long-term nominal Treasury bond yields

Daily data 3 January 2007 - 15 December 2010

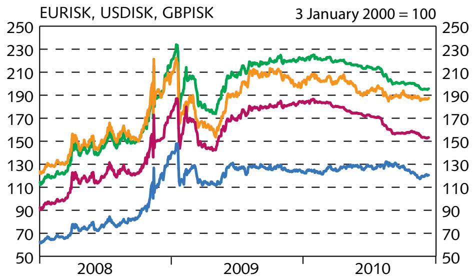


Source: Central Bank of Iceland.

Chart 3

Exchange rate of the króna

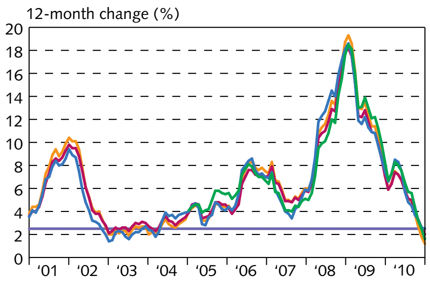
Daily data 3 January 2008 - 15 December 2010



Source: Central Bank of Iceland.

Chart 4

Inflation 2001-2010[1]



1. The core indices measure underlying inflation, with Core Index 1 excluding prices of agricultural products and petrol, and Core Index 2 excluding prices of public services as well. Core Index 3 also excludes the effect of changes in mortgage rates.
Sources: Statistics Iceland, Central Bank of Iceland.

Developments in September to December 2010

The Monetary Policy Committee has continued to lower interest rates since the last report was sent to Parliament in September 2010. At summer-end, the interest rate on deposit institutions' current accounts was 5.5%, and the maximum bid rate on 28-day certificates of deposit was 6.75%, but these interest rates are the primary determinants of short-term market rates.[1] Following the MPC's December meeting, the current account rate was 3.5%, the maximum bid rate on 28-day certificates of deposit was 4.25%, the seven-day collateralised rate was 4.50% and the overnight lending rate was 5.50%. At the December meeting the Bank's interest rate corridor was narrowed by 1.0 percentage point, to 2.0 percentage points, with the aim of reducing the volatility of short-term market rates and moving the overnight interbank rate closer to the centre of the corridor (see Charts 1 and 2).

In trade-weighted terms, the króna has depreciated by 0.3% since the beginning of September. Since then, the króna has depreciated by 0.7% against the euro and appreciated by 3.2% against the US dollar (see Chart 3). As expected, the Central Bank's regular purchases of foreign currency, which commenced on 31 August, appear not to have had any marked effect on the króna. Since then the Bank has bought 28.5 million euros from market makers.

It should be borne in mind that that broad-based restrictions on movement of capital to and from Iceland were imposed in November 2008. Without these capital controls, the Central Bank would have had to maintain higher interest rates. Following the November meeting the Governor gave a statement on the capital controls saying among other things that the strategy for removal of capital controls from August 2009 will be revised in view of changes in conditions and the experience so far. Furthermore, no fundamental changes will be made to current rules before March 2011, except if specific action was necessary in order to prepare for the comprehensive removal of controls on capital outflows (the statement is enclosed with this report).

Inflation has continued to decline since the beginning of September (see Chart 4). In August, headline inflation measured 4.5% according to the consumer price index, having come down from 8.5% in March 2010. By December 2010, it had dropped to 2.5%, or to 1.7% excluding temporary consumption tax effects, which is the appropriate monetary policy criterion. Inflation has therefore reached the Central Bank's inflation target. According to the forecast published in *Monetary Bulletin* in November the substantial slack in the economy, the appreciation of the króna, modest increases in wage costs, and diminishing inflation expectations all contribute to further disinflation through mid-2011, when inflation is forecast to bottom out at 1½%.

1. The Central Bank interest rate that is most important in determining short-term market rates may vary. For a long while, the Bank's 7-day collateral lending rate was the determinant of market rates, but since early in 2009, the interest rate on deposit institutions' current accounts with the Bank and the interest on certificates of deposit have been most important in interest rate formation. For further discussion, see *Monetary Bulletin* 2009/4, pp. 7-8 and 21-23.

Accompanying documents

The following documents are enclosed with this report:

1. Monetary Policy Committee statements from September 2010 to present.
2. Minutes of Monetary Policy Committee meetings from September 2010 to present.
3. Governor's statement on capital controls in November 2010.

On behalf of the Central Bank of Iceland Monetary Policy Committee,

Már Guðmundsson
Governor of the Central Bank of Iceland
and Chair of the Monetary Policy Committee

No. 28/2010
22 September 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank lowers interest rates

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.75 percentage points. The deposit rate (current account rate) will be 4.75%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 6.0%. The seven-day collateralised lending rate will be 6.25% and the overnight lending rate 7.75%.

Inflation continued to subside in August, after a marked decline since March. The CPI rose 4.5% year-on-year, or 3.8% excluding consumption tax effects. Weak economic activity and this year's appreciation of the króna continue to support disinflation.

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. The inflation outlook is also more or less unchanged since August. Inflation excluding tax effects is still expected to reach the Bank's inflation target by year-end and to fall somewhat below the target early in 2011. Inflation expectations have also continued to decline.

Since the MPC's August meeting, the króna has appreciated by roughly half a percentage point, both in trade-weighted terms and against the euro. As expected, regular purchases of foreign currency by the Central Bank, which commenced on 31 August, appear not to have affected the stability of the króna. 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 all continue to support the exchange rate.

The Third Review of the Government-IMF economic programme is now likely to be completed by the end of September. Once completed, the prerequisites for the resumption of capital account liberalisation will be in place as regards the foreign exchange reserves and macroeconomic stability. Furthermore, uncertainty about the strength of the financial system has been significantly reduced by the recent Supreme Court judgment on the reference interest rate to be used in loan agreements with non-binding exchange rate linkage clauses. The conditions for removal of the capital controls are therefore closer to being met than they were in August, creating some short-term complications for monetary policy.

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.

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank interest rates lowered

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates by 0.75 percentage points. The deposit rate (current account rate) will be 4.0%, and the maximum bid rate for 28-day certificates of deposit (CDs) will be 5.25%. The seven-day collateralised lending rate will be 5.5% and the overnight lending rate 7.0%.

Inflation continued to subside in September and October, after a marked decline since March of this year. The CPI rose 3.3% year-on-year in October, or 2.6% excluding consumption tax effects, which is close to the inflation target. Weak economic activity, declining inflation expectations, and this year's appreciation of the króna continue to support low and stable inflation.

According to the forecast published in *Monetary Bulletin* today, the economy will be somewhat weaker this year and in 2011 than the Central Bank had forecast in August. However, recovery is still expected to begin in the second half of this year. Inflation has subsided faster than was forecast in August, and the outlook is for inflation to be at target by year-end, fall below 2% next year, and subsequently return to target.

Since the MPC's September meeting, the króna has appreciated by nearly 1% in trade-weighted terms but has weakened slightly against the euro. As expected, the Central Bank's regular purchases of foreign currency, which commenced on 31 August, appear not to have had any marked effect on the króna. 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 all continue to support the exchange rate.

The Monetary Policy 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 prospect of removing the capital controls creates 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.

No. 34/2010
8 December 2010

Statement of the Central Bank of Iceland Monetary Policy Committee

Central Bank interest rates lowered

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has decided to lower the Bank's interest rates. The deposit rate (current account rate) is lowered by 0.5 percentage points, to 3.5%, and the maximum bid rate for 28-day certificates of deposit (CDs) and the seven-day collateralised rate are lowered by 1.0 percentage point each, to 4.25% and 4.5% respectively. Finally, the overnight lending rate is lowered by 1.5 percentage points, to 5.5%.

With this decision, the Bank's interest rate corridor is narrowed by 1.0 percentage point, to 2.0 percentage points, with the aim of reducing the volatility of short-term market rates and moving the overnight interbank rate closer to the centre of the corridor. Hence, the overall monetary stance is eased by somewhat less than the change in the centre of the corridor.

Inflation continued to subside in November, after a marked decline since March of this year. The CPI rose 2.6% year-on-year in November, or 1.8% excluding consumption tax effects. The inflation target of 2½% has therefore been achieved. Services price inflation has contributed most to headline inflation over the past twelve months, with public services prices rising particularly sharply. The appreciation of the króna, declining inflation expectations, and the slack in the economy continue to contribute to low and stable inflation.

National accounts data released since the last decision suggest a somewhat weaker economy than was assumed in the November *Monetary Bulletin*, although it should be kept in mind that early releases of national accounts data are often subject to major revisions. Recovery seems to have begun in Q3/2010, in line with the November forecast, although it seems somewhat weaker than was projected then. Inflation has been slightly lower than was implied in the November forecast, but as before, the outlook is for it to fall temporarily below the target in 2011.

Since the MPC's November meeting, the króna has remained broadly unchanged in trade-weighted terms but has appreciated by 1½% against the euro. As expected, the Central Bank's regular purchases of foreign currency, which commenced on 31 August, appear not to have had any marked effect on the króna. 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 all continue to support the exchange rate.

The Monetary Policy Committee considers that, if the króna remains stable or appreciates and inflation subsides as forecast, there may yet be some scope for further monetary easing. However, the prospect of removing the capital controls creates 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.

Minutes of the Monetary Policy Committee meeting

September 2010

Published: 6 October 2010

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.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2010

Published: 17 November 2010

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 meetings held on 1-2 November 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 3 November, 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 22 September interest rate decision, as reflected in the baseline forecast and risk analysis published in *Monetary Bulletin* 2010/4 on 3 November.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.4% higher at the time of the November MPC meeting than at the September meeting. Between meetings, the króna appreciated by 1.5% against pound sterling and by 5.1% against the US dollar but depreciated by 1.1% against the euro.

The volume in the interbank foreign exchange market continues to be low. The Central Bank has bought 21.5 million euros from market makers since it began regular purchases of foreign currency at the end of August.

In the offshore market, trading volume has been low since the last MPC meeting, and the króna has traded at 225-245 against the euro.

Risk premia on the Republic of Iceland as measured by the CDS spread have been broadly stable since the September meeting. The CDS spread on sovereign debt was 280 basis points at the November meeting, as opposed to 300 basis points at the September meeting. Iceland's CDS spread has not followed the developments seen in other high-CDS European countries, whose spreads have risen in recent weeks.

About 64 b.kr. worth of certificates of deposit (CDs) were outstanding as of the November meeting, approximately 8 b.kr. more than at the time of the September meeting.

Overnight interbank market rates had temporarily risen from 5.0% to 6.25% in the week prior to the meeting, reflecting unforeseen fluctuations in the liquidity position of financial institutions close to the end of the month. Trading volume in the interbank market amounted to 41.5 b.kr. since the last MPC meeting, with volume concentrated in overnight transactions.

Since the September meeting, Treasury bond yields had increased by 0.55-1.18 percentage points, and yields on indexed HFF bonds had risen by 0.51-0.77 percentage points.

Preliminary figures on the banking system in September showed that outstanding loans to residents decreased by 2.8% from the previous month, with foreign currency-denominated loans declining by 4.2%. Loans to companies decreased by 2.5%, while total lending to households fell by 0.3%. The money supply also continued to decline.

Since the announcement of the MPC decision on 22 September, the real effective policy rate (approximated as the simple average of Central Bank deposit and maximum CD rates) had increased by 1.2 percentage points in terms of current year-on-year inflation. In terms of most forward-looking measures (Central Bank inflation forecast and corporate and household inflation expectations), the real rate rose after the September meeting but fell in terms of the breakeven inflation rate in the bond market. The risk-adjusted short-term interest rate differential with main trading partners had increased by 0.3 percentage points.

Market expectations concerning the forthcoming rate decision indicated that financial institutions' economics departments expected the MPC to lower the policy rate by 0.5-0.75 percentage points, based on inflation prospects and the domestic economic situation. They argued that uncertainty related to the liberalisation of the capital controls would prevent the MPC from taking bigger steps in easing the policy stance. Market makers and brokers expected rates to be lowered by 0.5-1.0 percentage points (with most expecting a 0.75 percentage points cut), and they viewed the MPC's emphasis on the capital controls as weighing more heavily than the emphasis on the domestic economy and inflation outlook.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in October, global growth is expected to reach 4.8% in 2010 and 4.2% in 2011, broadly in line with the IMF forecast of July 2010. The forecast for world trade continues to be revised upwards, and the IMF now expects trade to grow by 11.4% this year, roughly 2 percentage points more than in its July forecast. The latest OECD forecast, published in May 2010, projects 10.6% growth in world trade this year. The IMF forecast for world trade in 2011 has also been revised upwards, by 1 percentage point, to 7%.

Iceland's merchandise trade surplus was 10.6 b.kr. in September. The value of merchandise exports was almost 50 b.kr., while the value of imports was 39 b.kr. Exports grew by roughly 20% month-on-month in September, with a substantial increase in all major export categories. Imports grew by almost 14%, with an increase in the range of 6-19% month-on-month recorded in most major import components except fuel, which declined by 10% from the previous month.

In September, the export value of aluminium increased by 21% month-on-month, following a contraction in the three preceding months. There was some rise in aluminium prices in September, but growth in exports was due mainly to unexpectedly low exports in previous months. The price of aluminium continued to rise in the first part of October and should raise the value of aluminium exports in October, as production levels have been stable.

The price of marine products has been rising since late 2009, albeit with an interlude in July and August, and increased by 5% month-on-month in September.

The domestic real economy and inflation

All indicators of labour utilisation show a year-on-year decline in Q3/2010. Employed persons as a share of the population aged 16-74 fell by 1 percentage point year-on-year in Q3. Total hours worked fell by 2.1% due to a ½-hour shorter work week and a 0.9% fall in the number of persons at work. The drop in total hours was most prominent in the core age group (25-54 years), whereas the oldest age group saw an increase.

The wage index rose by 0.3%, month-on-month in September, after no change in August. Wages increased by 1.9% quarter-on-quarter in Q3/2010, while inflation fell by 0.6%; thus real wages rose by 2.5%.

Registered unemployment fell from 7.7% in Q2 to 7.1% in Q3. Adjusted for seasonality, unemployment rose by 0.6 percentage points in Q3, to 8.7%. According to the Statistics Iceland labour force survey, unemployment was 6.4% in Q3, down from 8.7% in Q2.

Indicators suggest that the labour market may soften somewhat further. Firms planning to shed staff in the next six months outnumber those planning to recruit by 10 percentage points, according to the Capacent Gallup survey carried out in September among Iceland's 400 largest firms. However, fewer firms were considering laying off staff in September than in a comparable survey in June, or a quarter of firms, and more were considering adding on staff. However, firms' plans to recruit and lay off staff are broadly unchanged from the same time last year.

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.

Statistics Iceland's nationwide housing price index, published in October, declined by 1% from the month before. The greater Reykjavík housing price index, calculated by the Icelandic Property Registry, increased by 0.4% in September from the previous month, and the change was the same when adjusted for seasonality. The index had fallen by 3.2% year-on-year in nominal terms and by 6.7% in real terms.

After a slight decline in September, the Consumer Sentiment Index plunged in October, hitting its lowest point since August 2009. Only once before – in November 2008, following the financial crisis – has the index fallen so sharply month-on-month. All sub-indices fell considerably in October, with the index of expectations towards the overall economic situation six months ahead declining the most.

According to Capacent Gallup's September business sentiment survey, executives continue to be pessimistic about the current economic situation. Furthermore, they were more pessimistic about the economic situation six months ahead than in the last survey in June, with roughly half of firms' executives expecting the situation to remain unchanged and 29% expecting it to deteriorate. In comparison, when asked in June, 31% of firms expected the economic situation to improve over the next six months. On the other hand, they were more optimistic looking twelve months ahead, with 45% of firms expecting economic conditions to improve.

Despite firms' bleak view of the overall economic outlook, they were slightly more upbeat about domestic demand, with a quarter of executives expecting domestic demand to grow over the next six months, as compared with 17% in June. Compared to the survey in June, all sectors except financial services have a higher share of participants expecting domestic demand to increase, with the largest increase in construction and specialised services sectors.

The median executive expects inflation to measure 2.5% one year ahead, a 0.5 percentage point decline from the survey in June. However, the median executive expects inflation to measure 4% in two years, 1 percentage point less than in the survey in March.

When asked about firms' pricing decisions, 58% of executives expected their prices to remain unchanged over the next six months, and a third believed prices would rise, which is in line with the survey carried out in March. A third of retail firms expect to cut prices in the next six months, compared to 6% in March.

In another Capacent Gallup survey in September, household inflation expectations one year ahead also declined from the previous survey (in June), by two percentage points, measuring 6% according to the median. They remain high despite the rapid decline in inflation over the course of the year. The median household expected twelve-month inflation to measure 5% in two years, which is two percentage points lower than in June.

The consumer price index (CPI) increased by 0.74% month-on-month in October, after remaining unchanged in September. Annual inflation measured 3.3% in October, down from 3.7% the month before. Underlying inflation as measured by the CPI excluding tax effects was close to the inflation target, at 2.6%.

In October, the largest contribution to the rise in the CPI was the pre-announced increase in utility prices, which rose by 23.5% (CPI effect 0.27%). Prices of food and non-alcoholic beverages rose by 0.7% (CPI effect 0.1%), due mainly to higher domestic grocery prices, as imported grocery prices remained unchanged month-on-month. The cost of owner-occupied housing increased by 0.9% and is now 4.5% lower than a year ago. International airfares, a very volatile sub-component, increased by 15.6% (CPI effect 0.13%), after having declined by roughly 11% in September. On an annual basis, they are 3% lower than a year ago.

According to the baseline forecast published in the *Monetary Bulletin* on 3 November, the króna will appreciate slightly as the forecast horizon progresses. Global economic developments have been broadly in line with the Bank's earlier forecasts, but in the first half of the year the domestic economy has been somewhat less resilient than expected. There are signs, however, that the contraction in Q2 was smaller than preliminary figures from Statistics Iceland suggest. The outlook is for GDP to contract more this year, and grow less in 2011, than was forecast in August. It is still assumed, however, that GDP bottomed out in Q2 and recovery began in Q3. The forecast assumes that output growth will be almost 3% 2012-2013. As a result, it is projected that employment levels will start to rise beginning in mid-2011 and that unemployment will gradually fall throughout the forecast period.

The exchange rate of the króna has remained relatively stable since the publication of the *Monetary Bulletin* in August, even though the Central Bank has lowered interest rates by 1.75 percentage points in two steps. Inflation has subsided more quickly than was forecast in August and is now expected to align with the Bank's inflation target at year-end, somewhat earlier than previous forecasts suggested. Inflation is also forecasted to rise less than previously anticipated in early 2011 because of smaller consumption tax hikes. Owing to a stable exchange rate, modest wage rises during the forecast horizon, declining inflation expectations, and spare output capacity, inflation will decline more rapidly through mid-2011, when it will begin to rise again towards the inflation target.

The *Monetary Bulletin* also discusses key risks to the outlook, which are judged to be more on the downside. Recovery could prove weaker if the global recovery suffers a setback, if heavy household indebtedness curtails private consumption growth more than the forecast assumes, and if investments in energy-intensive industry are delayed still further. The same applies if wage rises are larger than is consistent with price stability and if the restraint measures in the National Budget bill are not successful, although this could have a transitory stimulative effect. On the other hand, the recovery could be stronger if a sharper decline in risk premia leads to a more rapid appreciation of the real exchange rate towards its long-term equilibrium, or if stronger FDI inflows lead to a more rapid recovery of business investment compared to the baseline forecast.

II The interest rate decision

The Governor gave an account of the Icelandic delegation's meetings with IMF representatives, and his meetings with other central bankers, rating agencies and financial institutions at the IMF's Annual Meeting in Washington, DC. Also discussed were the recently completed third review and the preparation of the fourth review of the economic programme supported by the IMF Stand-By Arrangement. The Governor also informed the MPC of the restructuring of private debt.

The Committee observed that inflation had continued to subside in September and October, after a marked decline since March of this year. In the MPC's view, weak economic activity, declining inflation expectations, and this year's appreciation of the króna will continue to support low and stable inflation.

The Committee noted that, according to the forecast published in *Monetary Bulletin* on 3 November, the economy will be somewhat weaker this year and in 2011 than the Central Bank had forecast in August. However, recovery is still expected to begin in the second half of this year. Furthermore, inflation had subsided faster than was forecast in August.

The MPC observed that since the MPC's September meeting, the króna had appreciated by nearly 1% in trade-weighted terms but had weakened slightly against the euro. As the Committee had expected, the Central Bank's regular purchases of foreign currency, which commenced on 31 August, appeared not to have had any marked effect on the króna. In the MPC's view, the capital controls, developments in the 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 exchange rate.

The Committee discussed prospects for the lifting of the capital controls and the implications for monetary policy. The Committee also discussed the role of exchange rate stabilisation as an interim goal of monetary policy and some members argued that the importance of that goal was gradually declining as disinflation continued and the restructuring of domestic balance sheets progressed while others maintained that a lower exchange rate might generate increased wage inflation.

Members discussed the possibility of lowering the policy rate by 0.75 to 1.0 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 4.0% and 5.25%, respectively, the seven-day collateral lending rate to 5.5%, and the overnight lending rate to 7.0%.

All MPC members supported the Governor's proposal, although one member would have preferred a somewhat larger rate cut, arguing that the economy had turned out weaker than expected and that inflation was subsiding faster. This member agreed, however that the difference was small enough to accept the Governor's proposal.

The Monetary Policy 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 prospect of removing the capital controls creates 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, 8 December 2010.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting
December 2010

Published: 22 December 2010

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 meetings held on 6-7 December 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 8 December, 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 3 November interest rate decision.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.5% higher at the time of the December MPC meeting than at the November meeting. Between meetings, the króna depreciated by 0.7% against the pound sterling and by 2.3% against the US dollar but appreciated by 2% against the euro.

The volume in the interbank foreign exchange market continues to be low. The Central Bank has bought 29 million euros from market makers since it began regular purchases of foreign currency at the end of August.

In the offshore market, trading volume has been low since the last MPC meeting, and the króna has traded at 230-242 against the euro.

Risk premia on the Republic of Iceland as measured by the CDS spread have been broadly stable since the November meeting, or 271 basis points at the December meeting, as opposed to 280 basis points at the November meeting.

About 57.8 b.kr. worth of certificates of deposit (CDs) were outstanding as of the December meeting, approximately 6 b.kr. less than at the time of the November meeting.

Overnight interbank market rates had continued to fluctuate between meetings. Trading volume in the interbank market amounted to 67 b.kr. since the last MPC meeting, with volume concentrated in overnight transactions, although there had also been transactions on other maturities for the first time since November 2008.

Since the November meeting, Treasury bond yields (apart from the series maturing in December 2010) had fallen by 0.66-1.22 percentage points. Yields on the shortest indexed HFF bond series had risen by 0.31 percentage points, while yields on other HFF series had fallen by 0.16-0.32 percentage points.

Preliminary figures on the banking system in October showed that outstanding loans to residents rose by 3.3% from the previous month. This increase is due mainly to the fact that Straumur, previously classified as a commercial bank, is now classified as a holding company. Loans to companies decreased by 0.7%, while total lending to households fell by 0.6%. M3 continued to decline as well; mainly reflecting a shift from deposits to mutual funds, whereas M1 and M2 have been broadly stable.

Since the announcement of the MPC decision on 3 November, the real effective policy rate (approximated as the simple average of Central Bank deposit and maximum CD rates) had risen by 0.7 percentage points in terms of current year-on-year inflation. In terms of the one-year breakeven inflation rate in the bond market, the real rate rose by 1.6 percentage points. The risk-adjusted short-term interest rate differential with main trading partners had fallen 0.5 percentage points due to movements in domestic rates.

Financial institutions' economics departments and market makers expected a 0.5-0.75 percentage point rate cut. A cut of this magnitude was also implied by developments in bond yields. Despite some difference in opinion on future rate decisions, the majority seems to expect further cuts in early 2011.

Outlook for the global real economy and international trade

According to the latest OECD forecast, published in November, global growth is expected to reach 4.6% in 2010, which is unchanged from the last OECD forecast in May 2010, and 4.2% in 2011, which is slightly more modest growth than previously expected. The forecast is broadly in line with the IMF forecast of October 2010. The OECD forecast for world trade continues to be revised upwards, however, and the OECD now expects trade to grow by 12.3% this year, almost 2 percentage points more than in its May forecast. The forecast for world trade in 2011 is broadly unchanged at 8.3%.

Iceland's goods trade surplus measured 10.1 b.kr. in October. Goods exports were valued at almost 47 b.kr., while imports totalled just under 37 b.kr. Exports contracted by roughly 5% month-on-month in October, with some contraction in most major export categories. Imports also contracted by roughly the same month-on-month, with contractions in most major categories apart from investment goods, which increased by almost 15% month-on-month.

In October, the export value of aluminium fell by roughly 1% month-on-month, despite some rise in prices. Prices came down again in November, but the export value of aluminium is expected to increase somewhat due to delays in the price effects on the export value of aluminium from Iceland.

Marine product prices have been rising since late 2009, apart from a short downturn in July and August, and increased by 1% month-on-month in October.

Preliminary numbers suggest that the trade surplus in November was 10.4 b.kr., with both export and import values increasing by roughly 3% month-on-month. The rise in export values is led by a 7% increase month-on-month in the export value of industrial goods.

The domestic real economy and inflation

Preliminary quarterly national accounts figures from Statistics Iceland, published on 7 December, show that the Icelandic economy was somewhat weaker in Q3/2010 than was assumed in the Central Bank's latest forecast, which appeared in the *Monetary Bulletin* 2010/4 in November. All subgroups are weaker than forecast in November except private consumption, which was in line with the forecast.

All methods of seasonal adjustment suggest that GDP grew in Q3 from the previous quarter after having contracted since Q4/2008. This is in line with Central Bank of Iceland forecasts this year, but growth is weaker than was anticipated in the November forecast.

The contribution to quarterly GDP growth in Q3/2010 was negative from all subgroups except private consumption, with the negative contribution from net trade the most significant. After three years of a positive contribution, the contribution of net trade to GDP appears likely to be negative this year.

Compared to Q1 and Q2, Q3 shows a much smaller contraction year-on-year, or 1.6% compared to over 7% in Q1 and Q2. GDP fell by 5.5% in the first three quarters of the year, whereas a 4.2% decline was forecast in November.

Revised national accounts figures show that the economy was slightly weaker in the first half of 2010 of the year than preliminary figures from September had indicated, and ½ percentage point weaker than forecast in November. The main reason for the revision in the first half of the year is weaker private and public consumption according to Statistics Iceland, and weaker investment than assumed in the CBI forecast.

The current account surplus was 24 b.kr., or 5.9% of GDP, in Q3/2010. This is a significant improvement from the previous quarter when there was a deficit of 12% of GDP. The current account surplus is due to the 35 b.kr. surplus on the service account and a 22 b.kr. surplus on the goods account, which offset the 32 b.kr. deficit on the income account. The current account surplus adjusted for accrued income and expense of financial institutions in winding-up proceedings was still larger at almost 62 b.kr., or 15.3% of GDP.

Registered unemployment was 7.7% in October, up from 7.1% in August. Adjusted for seasonality, unemployment was unchanged at 9.0%.

The wage index rose by 0.3% month-on-month in October. The twelve month rise in nominal wages was 6.0%, while real wages increased by 2.2%.

Statistics Iceland's nationwide housing price index, published in November, rose by 0.4% from the previous month. The greater Reykjavík housing price index, calculated by the Icelandic Property Registry, increased by 0.9% month-on-month in October, and the same change was measured when adjusted for seasonality. Activity in the real estate market fell month-on-month in October and November, after a temporary pick-up in September. Some 38% more contracts were concluded in October and November than in the same period last year, although the number of contracts remains very low in a historical context.

Consumer sentiment improved somewhat in November after having fallen in October. All sub-indices rose, but not enough to reach the September values.

Inflation continued to subside in November, after a marked decline since March. The consumer price index (CPI) rose by 0.05% month-on-month and by 2.6% year-on-year, or 1.8% excluding consumption tax effects. Seasonally adjusted, the CPI has risen by just under 0.5% in the last three months, a 1.9% rise on an annual basis.

The main contribution to the CPI in November was an 18.7% decline in international airfares, following an almost 16% rise in October, but monthly developments in international airfares remain volatile. Prices of petrol and oil increased by 2.6%, and utility prices rose by 7%.

The exchange rate pass-through from the appreciation of the króna continues to emerge gradually in import prices. Prices of imported food and non-alcoholic beverages have declined by 3% year-on-year. Overall, imported goods prices (excluding alcohol and tobacco) are 1.4% higher than a year ago, compared to an annual increase of 14.6% last January.

II The interest rate decision

The Governor informed the Committee of the status of the dispute over compensation to depositors in foreign branches of Landsbanki and the agreement between the Government, on the one hand, and credit institutions and pension funds, on the other, concerning measures intended to respond to household debt problems. The Committee discussed the Central Bank's newly published *Financial Stability* report and recent steps in the financial sector restructuring process.

The MPC noted that the inflation target of 2½% had been achieved. Inflation continued to subside in November after a marked decline since March 2010. In the MPC's view, factors leading to the appreciation of the króna, declining inflation expectations, and the slack in the economy will continue to contribute to low and stable inflation.

The MPC observed that national accounts data released since the last decision suggested a somewhat weaker economy than was assumed in the November *Monetary Bulletin*, although early releases of national accounts data are often subject to major revisions. Recovery seems to have begun in Q3/2010, in line with the November forecast, although the Committee noted that it seemed somewhat weaker than was projected then. On the other hand, inflation had been slightly lower than was implied in the November forecast but, as before, looks set to fall temporarily below the target in 2011.

The Committee noted that, since the MPC's November meeting, the króna had remained broadly unchanged in trade-weighted terms but had appreciated against the euro. The Central Bank's regular purchases of foreign currency, which commenced on 31 August, appeared not to have had any marked effect on the króna to date. In light of exchange rate developments and the experience of foreign currency purchases, the MPC discussed the advantages and disadvantages of stepping up regular purchases of foreign currency. 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 all continue to support the exchange rate.

The MPC discussed both the desirability and ways of reducing the volatility of short-term market rates and moving the overnight interbank rate closer to the centre of the Bank's interest-rate corridor. In light of the discussion, the Governor suggested that the corridor be narrowed by 1.0 percentage point, to 2.0 percentage points. Four members supported the Governor's proposal while one voted against it, arguing that there was no apparent need to narrow the corridor. This member also objected to the nature of the proposal, which was a departure from the usual procedure of voting on specific rates. This member also felt that not enough time was given to consider the proposal adequately.

Members discussed the possibility of lowering the policy rate by 0.75 to 1.0 percentage points. In light of the discussion, the range of views expressed, and the Committee's decision to narrow the interest rate corridor by 1.0 percentage point, the Governor proposed that the deposit rate (current account rate) be lowered by 0.5 percentage points, to 3.5%; that the maximum bid rate for 28-day certificates of deposit (CDs) and the seven-day collateralised rate be lowered by 1.0 percentage point each, to 4.25% and 4.5% respectively; and that the overnight lending rate be lowered by 1.5 percentage points, to 5.5%. The MPC members agreed that the Governor's proposal implied that the overall monetary stance would be eased by somewhat less than the change in the centre of the corridor, although an exact measurement of the change in the stance would be difficult.

Four MPC members supported the Governor's proposal, although two members would have preferred a slightly different decision. Of these two members, one would have preferred a 0.25 percentage point smaller cut in all Central Bank rates, while the other would have preferred a 0.5 percentage point smaller cut in the deposit rate. One member voted against the Governor's proposal. While agreeing on narrowing the corridor, the member suggested reducing rates by 0.25 percentage points less than the Governor's proposal, thus lowering the centre of the interest rate corridor by 0.75 percentage points rather than 1.0 percentage point.

The Monetary Policy Committee considers that, if the króna remains stable or appreciates and inflation subsides as forecast, there may yet be some scope for further monetary easing. However, the prospect of removing the capital controls creates 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, 2 February 2011.

3 November 2010

Statement on capital controls

This statement is given in order to explain the policy framework and current intentions regarding the removal of capital controls. The only new specific information is in Point 8.

1. Comprehensive capital controls were introduced in November 2008 as a part of the Government economic programme, which is supported by the IMF, in order to prevent serious difficulties as regards Iceland's balance of payments, and with the aim of stabilising the exchange rate without overreliance on the interest rate tool. The controls are a deviation from Iceland's obligations under the EEA Agreement to uphold free capital movements. Under the EEA Agreement, such controls are permitted only as a short-term emergency measure. The measures have been notified to EEA institutions, as is provided for in the Agreement, without any objections. However, it would be a breach of the EEA Agreement if best efforts are not made to lift the capital controls once the conditions that created the emergency have been overcome.
2. It has therefore been one of the aims of the Government programme to create the conditions for lifting the capital controls. In addition, capital controls have economic and social costs that tend to accumulate over time.
3. In August 2009, the Central Bank published a strategy for lifting the capital controls. The strategy was developed in consultation with the Ministry of Business Affairs and the IMF and was approved by the Government. As is stipulated in the original strategy, the first step of lifting controls on capital inflows and all subsequent associated outflows was taken on 1 November 2009. It is important to bear in mind that, although the strategy provides a broad blueprint for lifting controls on capital outflows, it does not specify any dates. Instead, it was stated that sequential steps in lifting the controls would depend on conditions. The pace of lifting the controls would thus depend on whether specific conditions were fulfilled and how well, or badly, preceding steps went.
4. The strategy lists several key conditions for lifting the capital controls. The most important ones were: 1) macroeconomic stabilisation, including the implementation of a credible plan for fiscal sustainability and declining inflation; 2) a sound financial system; 3) an

adequate level of foreign exchange reserves. These conditions have formed the basis for the Central Bank and MPC statements on capital controls. Two of these conditions are being met, but the required financial soundness is not fulfilled, partially due to uncertainty regarding the capital position of the banking system following two Supreme Court rulings. In the last Letter of Intent written to the IMF, the Icelandic authorities committed to recapitalising the banking system before year-end should it be needed. This is a necessary condition for financial sector soundness, but it might not be a sufficient condition.

5. The MPC does not develop or take decisions on the strategy for lifting capital controls, although the Central Bank seeks its views and advice on the issue. Monetary policy does, however, take the existing strategy into account and the prospects for its implementation. In doing so, the MPC has taken note of the conditions mentioned above. The evolution of MPC statements should be seen in that light.

6. Although the strategy from August 2009 has not been formally revised, Central Bank officials have stated, and this was echoed in the August MPC statement, that the strategy may need to be revised in view of the change in conditions and the experience so far. The revised strategy will be designed by the Central Bank in consultation with the Ministry of Economic Affairs and finally endorsed by the Government. This is in line with the process used to prepare the original strategy. A revision of the strategy does not imply a departure from the goal of lifting capital controls in the coming period, but rather it recognises the need to reconsider the manner in which the controls will be lifted in light of recent experience and changed conditions.

7. Provided legal or other impediments are not uncovered prior to the announcement of a revised strategy, some action might be taken in order to prepare for the comprehensive removal of controls on capital outflows. This might include measures to allow legally acquired offshore krónur to be swapped through controlled auctions against legal holdings of foreign assets by domestic residents, and to allow legally acquired offshore krónur to be invested in targeted long-term business ventures or other specific projects in Iceland.

8. Given that the issue of a potential short-fall in the capital position of the banking system might not be fully addressed until year-end, it is not realistic that any other steps than those described in Point 7 will be taken to lift the controls on outflows this year. Furthermore, no such steps will be taken until a revised strategy has been made public. In addition, even if such a strategy were ready earlier, no fundamental

changes will be made to current rules before March 2011, except those that might be needed in order to execute the planned action mentioned in Point 7. This commitment is supported by the Minister of Economic Affairs. It should be borne in mind that the enabling legislation for the capital controls will at present expire at the end of August 2011. However, a proposal to extend the legislation might become part of the revised strategy that will be announced before March 2011.

Már Guðmundsson
Governor