Minutes of the Monetary Policy Committee meeting, April 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 April 7, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of April 8, and the communication of that decision.

I Economic and monetary developments

During its discussions, the MPC emphasised the following new information that has emerged since the previous interest rate decision on March 19:

Financial markets

The depreciation of the króna beginning in early March had continued. The trade-weighted exchange rate index (TWI) was 8.7% higher on April 7 than at the publication of the last MPC statement on March 19.

Short-term interest rates in Iceland's main trading partner countries had declined since the monetary policy decision in March. The spread between the domestic policy rate and the ECB policy rate had increased by 0.25 percentage points since end-2008. In the first week of April, the three-month interbank interest rate differential against the euro was roughly 2.3 percentage points higher on average than in the first week of March.

Volume in the foreign exchange market was ISK 1 billion in the first week of April, compared to ISK 350 million in the first week of March; however, these figures only reflect trade between the commercial banks with most of the trading being concluded in-house since the interbank foreign exchange market resumed operation in December.

Forward interest rates imply that the policy rate reduction in March was in line with market expectations. On the other hand, yields on indexed HFF bonds rose immediately after the policy rate reduction, which may indicate that the rate cut was smaller than expected. Indexed HFF bond yields fell again after the publication of CPI figure at the end of March.

During the two-week period immediately following the last interest rate decision, average inflation expectations five years ahead, as implied by the breakeven inflation rate in the bond market, were unchanged relative to the two-week period prior to the decision.

Outlook for the global real economy and international trade

The outlook for the world economy and world trade has deteriorated markedly since the March interest rate decision. According to a new OECD forecast, growth in OECD countries has been revised downwards by almost 4 percentage points from the previous OECD forecast to -4.3% for this year. The outlook for the domestic export sector has deteriorated further, as the OECD estimates that world trade will contract by 13% in 2009 and by slightly less for Iceland's main business partners.

This will make export-led growth more difficult still. The bleaker outlook is supported by a new Capacent Gallup survey, which shows that half of fish exporters expect foreign demand for their products to contract in the next six months and expect prices for their products to fall by 10%.

According to preliminary figures, the trade surplus in Q1/2009 was ISK 14.6 billion. The surplus is primarily due to a 44% year-on-year drop in imports of goods and services.

In Q1/2009, preliminary data suggest that the real effective exchange rate measured in terms of relative CPI is broadly unchanged from the previous quarter, while it appreciated substantially in terms of relative unit labour costs due to a large decline in domestic labour productivity pushing up domestic unit labour costs.

The domestic real economy and inflation

Groceries turnover data for March indicate a continued contraction of domestic demand in Q1/2009. Groceries turnover contracted by more than 12% in real terms in Q1/2009, following a contraction of over 7% in the fourth quarter of 2008.

A Capacent Gallup survey of business sentiment conducted among Iceland's 400 largest companies during the period March 3-22 2009 shows that business confidence has recovered slightly from an all-time low in December. Although almost all participants view the current economic situation as bleak, as they did in December, the firms surveyed are more upbeat about the future economic situation. A majority of firms expect that the economy will start to recover in six to twelve months' time. Almost 30% of companies believe that the economic situation will improve in the next six months, while nearly 40% expect it to remain unchanged. Almost 60% of respondents believe that the economy will pick up over the next twelve months.

The survey shows similar results with regard to expectations of domestic demand, as almost 23% of firms expect domestic demand to increase in the next six months and half of participants expect it to remain unchanged.

The business sentiment survey indicates that the labour market will continue to weaken, although at a slower pace. Nearly one-quarter of the companies still want to cut back staff, compared with well over half in the December 2008 survey. Most businesses seem to have already made the changes needed in staffing levels, as 64% want to keep unchanged staffing levels, up from 40% in the previous survey in December. Roughly 13% of firms want to recruit staff over the next six months, as compared with almost 8% in December. Just under one-quarter of businesses in the greater Reykjavík area expressed an interest in cutting back on staff, more than twice the number in regional Iceland. The greatest change in recruitment plans was in the construction sector, where one-fifth of companies want to recruit staff now, as opposed to 5% in December.

When asked about inflation expectations, the median firm expects the CPI to remain unchanged over the next twelve months, compared to 15% inflation expectations last December. They expect twelve-month inflation to amount to 4% in two years' time, compared to 5.5% in October 2008. These figures are broadly in line with the inflation outlook in the Bank's forecast.

Finally, when asked about their pricing decisions, just over half of firms indicated that they expect their prices to remain unchanged over the next six months, while almost a third expect that their prices will decrease. In comparison, in October 2008 some 70% of participants expected to raise their prices in the next six months, but now only 17% expect to raise prices.

In February, the wage index was unchanged from the previous month but had risen by 6.7% year-on-year. Real wages were down by 0.5% month-on-month in February and by 9.3% since February 2008.

The CPI fell by 0.6% in March, bringing the 12 month rate of inflation down from 18.6% in January to 15.2%. The CPI has not declined month-on-month since the value-added tax on groceries was reduced two years ago, and it has not fallen by such a large margin in over two decades.

The drop in the CPI was driven mainly by a decrease in the housing component, which has begun to contribute more to the decline in the CPI; owner-imputed rent declined by just over 5% in March and has fallen 9% year-on-year. According to Statistics Iceland, nominal market prices have fallen by 11% year-on-year.

Prices of volatile items such as food and beverages, petrol, and international air fares dropped in March, leading to a decline in the CPI of 0.4 percentage points.

Prices of non-tradable goods such as real estate are declining rapidly; however, due to last year's depreciation of the króna and other factors tradable goods inflation remains high.

Just over half of the twelve-month inflation figure of roughly 15% is explained by the imported goods component, while only 5% of it is attributable to the overall housing component. Inflation in private services explains 18% of the increase.

The cost-push model forecasts relatively small monthly increases in the CPI in the next three months, with inflation in the second quarter likely to be in the 10-11% range, down from 17% in the first quarter.

II The interest rate decision

The Committee agreed that that the conditions for further monetary easing were in place. Economic developments since the March meeting had been broadly in line with expectations. Short-term indicators of domestic demand, such as turnover data, suggest that the contraction has continued in Q1/2009. Business confidence has recovered slightly from an all-time low. The labour market has also continued to soften, with unemployment registrations rising and wage pressures remaining subdued.

The Committee also stressed that recent developments indicate that inflation will continue to fall rapidly, broadly in line with the Central Bank's January forecast. The March number reflects this trend. Inflationary pressures have continued to subside. The CPI fell by 0.6% in March, bringing the twelve month rate of inflation down from 18.6% in January to 15.2%. The decline in inflation is mainly associated with a sharp contraction in domestic demand, as well as favourable exchange rate developments. Housing demand has been particularly weak, leading to a significant drop in the housing component of the CPI. Businesses' inflation expectations have also declined sharply.

The Committee discussed at length the recent developments in the domestic financial system, especially the foreign exchange market. Among the issues covered were the effectiveness of the capital controls, turnover in both the on- and off-shore markets, the extent of interest payments outflows and how these relate to trading volumes and price developments. Trading volume and price formation in the CDS market were also discussed as well as how reliable a measure of the risk premium on ISK denominated assets the CDS spread is. Finally, the Committee discussed how the level of the policy rate affects financial markets.

The Committee discussed recent exchange rate developments. The króna had depreciated by nearly 9% since March 19. The MPC did not consider it likely that its March 19 decision to lower the policy rate by one percentage point had made a significant impact on the króna. The wide interest rate differential between the króna and the major currencies should continue to provide scope for careful easing of monetary restraint without jeopardising the stability of the króna. Since end-2008, the spread between the domestic policy rate and the ECB policy rate has widened slightly.

The Committee argued that the weakness of the króna was apparently caused by transitory factors, such as relatively large seasonal interest payments on non-residents' ISK holdings. Moreover, there was some evidence that the capital controls were being circumvented. However, the authorities had addressed this problem by closing loopholes in the legislation and had decided to increase surveillance.

While the trade account has moved into surplus, there remains considerable uncertainty concerning the overall current account. Furthermore, in view of long-term fundamentals, the króna appeared likely to recover from its recent position. Such a recovery is consistent with the view expressed by the MPC during its deliberations in March.

Market interventions by the Central Bank were limited in March, compared to January and February 2009. Hence, currency reserves were not used to counter the transitory outbound flows following from seasonal interest payments. The interest payments in the next months are expected to be a fraction of the March figures.

The MPC agreed that, while the long-term goal of monetary policy remains the inflation target, the objective of stabilising the exchange rate must guide monetary policy in the interim because of the need to protect vulnerable private sector balance sheets during the restructuring phase.

The MPC sees the capital controls as an unfortunate but indispensable element of a strategy aimed at protecting balance sheets and promoting sustainable recovery while preventing disorderly capital outflows. The Central Bank regularly assesses the effectiveness of the capital controls and explores the possibilities for their gradual, systematic easing as soon as conditions permit.

In its March 19 statement, the MPC concluded that, due to remaining uncertainties, the conditions for lifting the capital controls were not yet in place. Increased clarity about balance of payments prospects, the medium-term fiscal consolidation plan, and progress in financial sector restructuring are the prerequisites for a significant easing of controls. The MPC agreed that current domestic and external circumstances do not yet allow for the removal of the capital controls without compromising stability.

The Governor informed the MPC that the Central Bank is in the process of reviewing selected measures managed by the Central Bank that may allow the most impatient investors locked in by the capital controls to convert their holdings of ISK, in a way that is consistent with the target of maintaining the currency reserves of the Bank.

All Committee members agreed that inflation developments and conditions in the real economy supported a further easing of monetary policy. While the MPC agreed that the appreciation of the króna in January and February contributed to the benign inflation outcome, the Committee considered it unlikely that the weakness of the króna in March would slow down the disinflation process materially, given the sharp contraction in domestic demand.

In view of uncertainties about balance of payments prospects, the medium-term fiscal consolidation plan, and progress in financial sector restructuring, most members agreed that careful easing of monetary policy was still justified and that a policy rate cut in the range of 1.0 to 2.0 percentage points would be appropriate. These members argued that, by the time the MPC meets again in early May, many of the factors now subject to uncertainty would have become clearer. Furthermore, a new staff forecast would be available at the May meeting.

One member argued that a somewhat larger step was appropriate this time and suggested a rate cut in the range of 2.0 to 3.0 percent. He argued that under the regime of capital controls the very high interest rates could weaken the exchange rate in the short run, by increasing the flow of interest income in the FX market and over the medium term, by gradually increasing non-residents' ISK holdings. This would call for lower exchange rates in the future in order to generate a sufficient trade surplus to service the larger external debt. The positive effect of high interest rates on the exchange rate, working through reduced leakages in the system of capital controls, remained uncertain, since the most impatient foreign owners of ISK assets would want to leave the króna even at very high ISK interest rates. In terms of the financial crisis, the high interest rates were deepening the crisis by draining liquidity from the business sector and hence accelerating the pace of bankruptcies. Ex-ante real rates of interest were already quite high according to some measures of inflation expectations. As a result of the financial crisis, there was no reason to worry about inflation. Any increases in the CPI simply reflected exchange rate movements in response to changes in the supply and demand for foreign currency. Nevertheless, this member agreed with other Committee members that a gradual approach was still appropriate, and that attention should be paid to interest differentials to encourage the more patient holders of ISK assets to keep their positions.

In light of the discussion, the Governor of the Central Bank of Iceland proposed that the policy rate be lowered by 1.5 percentage points to 15.5%.

The Governor invited other MPC members to vote on the proposal. Four MPC members voted in favour of the Governor's proposal. The fifth member voted for a 2 percentage points cut in the policy rate.

The next MPC announcement is scheduled for Thursday, May 7, 2009.