



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

May 2010

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and other monetary policy instruments; furthermore, the Act states that “[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee’s decisions and premises upon which they are based.” In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of the individual MPC members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meetings held on 3 - 4 of May 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 May, 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 17 March interest rate decision, as reflected in the baseline forecast and risk analysis published in *Monetary Bulletin* 2010/2 on 5 May.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.2% higher at the time of the May MPC meeting than at the March meeting. Between meetings, the króna had appreciated by 1.3% against the euro, but depreciated by 2.9% against the pound, and 1.4% against the US dollar.

The Central Bank has not intervened in the foreign exchange market since early November. Volume in the foreign exchange market has been low, amounting to 3 m. euros in April.

Residents’ FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

In the offshore market, the króna had traded at 270-290 against the euro since the last MPC meeting. Trading volume remains low in that market as well.

Risk premia for the Republic of Iceland, as measured by the CDS spread, had subsided since the March meeting, while increasing substantially for many other countries, with increasing concerns about sovereign debt. The CDS spread for the Republic of Iceland was 376 basis points at the May meeting, down from 411 basis points at the March meeting.

Seven auctions of certificates of deposit (CDs) had been held since the March meeting, and about 77.2 b.kr. worth of CDs were outstanding as of the May meeting.

Overnight interbank market rates remained within the Central Bank's interest rate corridor and were 0.5 percentage points above the current account rate as of the May meeting. Trading volume in the interbank market had been 115 b.kr. since the last MPC meeting. Trading is limited, with volumes concentrated in overnight transactions.

The yield in the mid-April Treasury bill auction was 6.74%, compared with 7.75% in the mid-March auction. The yield on T-notes had also declined by 0.6 to 1 percentage points from the March meeting. At the same time, yields on indexed HFF bonds were broadly unchanged.

Since the MPC meeting in March, the Treasury has issued a 12.3 b.kr. worth of a new series of index-linked bonds, RIKS 21 0414. Their average yield in the last auction was 3.69%.

Since beginning of the year, the growth of banknotes and coins in circulation has subsided. Broader money has also started to decline year-on-year, mainly due to a contraction in the shortest-term time deposits. This contraction in money holdings is consistent with the banks' limited lending activity.

With the exception of HFF and pension fund mortgages, data on credit supply is not complete; however, based on the available information, the total stock of bank lending may have decreased in recent months. New HFF lending increased by 6% quarter-on-quarter in Q1/2010 but decreased by a third year-on-year.

Since the March meeting, the change in the monetary stance as measured by the real interest rate had varied, depending on the measure of inflation and inflation expectations. In terms of current inflation, the level of restraint had declined, measuring 0.2%. It had remained broadly unchanged in terms of the breakeven inflation rate in the bond market, which was 4.2%. It had increased in terms of household and corporate inflation expectations, which were 0.1% and 4.0% respectively, and the inflation forecast published in the 5 May *Monetary Bulletin*, which resulted in 2.1% real interest rates.

The risk-adjusted short-term interest rate differential against the major currencies has stayed broadly unchanged or decreased slightly since the last MPC meeting.

Outlook for the global real economy and international trade

According to the latest IMF forecast, published in April 2010, global growth is expected to reach 4.2% in 2010, which is similar to the IMF forecast published in January 2010. The forecast for output growth in Iceland's main trading-partner countries is also

unchanged at 1.3% in 2010. However, world trade has been revised upwards and is now expected to grow by 7% this year, 1.2 percentage points higher than in the previous forecast. This revision is due mainly to a projected rise in trade volumes in emerging and developing economies.

The merchandise trade surplus in Iceland was roughly 14 b. kr. in February and 11.5 b.kr. in March. The merchandise trade surplus in Q1/2010 was 32 b.kr., 3% larger than in the same quarter in 2009.

Export values in domestic currency, excluding irregular items such as aircraft and ships, increased by 2% quarter-on-quarter in Q1/2010 and were 18% higher than in the same quarter in 2009. The value of imports in domestic currency declined by 3% quarter-on-quarter in Q1, due to a fall in imports of consumer goods and a substantial decline in imports of transport equipment. The value of imports rose by 27% year-on-year in March, reaching 41.4 b.kr. The value of imports has not been this high in a single month since October 2008.

In March, nominal exports of aluminium increased by 12% month-on-month, as aluminium prices have continued to rise. Quarter-on-quarter, nominal exports of aluminium rose by 14%, while nominal exports of marine products fell by 9%. In total, nominal exports of industrial products increased by 11% quarter-on-quarter in Q1/2010.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, labour force participation was unchanged year-on-year in Q1/2010, as was the average work week. The decline in total hours worked was much smaller than it has been since the onset of the crisis, or 2.2% year-on-year, after a 6.7% drop in Q4/2009 and an 11% fall in 2009.

The wage index rose by 0.5%, month-on-month, in February and by 0.1% in March. Wages increased by 3.5%, year-on-year, in Q1/2010, and real wages fell by 3.7%

Registered unemployment rose from 7.9% in Q4/2009 to 9.2% in Q1/2010. According to the labour force survey, unemployment was 7.7% in Q1/2010, up from 6.7% in Q4/2009.

Indicators suggest that the labour market may soften somewhat further. According to the Capacent Gallup business sentiment survey carried out among Iceland's 400 largest firms, more firms intend to lay off staff in March than in a comparable survey carried out in December, and more are considering adding on staff. An April 2010 survey conducted by the Confederation of Icelandic Employers among its members also indicated that companies planning layoffs outnumber those planning new recruitment. It is estimated that the net reduction in staffing could amount to about 1,500 employees during the year.

A number of economic indicators, such as payment card and groceries turnover, as well as retail sales, suggest that domestic private consumption remained broadly unchanged between Q4/2009 and Q1/2010, while seasonally adjusted payment card turnover abroad rose for the second consecutive quarter, by roughly one-fifth.

After staying almost unchanged in March, the consumer sentiment index increased by 11 points in April, measuring over 50 points for the first time since October 2008. All

sub-indices rose, led by the sub-index for expectations about the future economic situation.

According to the Capacent Gallup business sentiment survey in February and March, executives continue to be downbeat about the current economic situation. While roughly 86% of firms considered the current economic situation bleak, they were less pessimistic about the outlook six months ahead than they were in December. In March, around 25% of companies believed that the economic situation would improve in six months' time, compared to 18% in December, and 26% of companies expected further deterioration of the economic situation, down from 43% in December. Roughly one-fourth of companies expected domestic demand to decline over the next six months, down from 42% in December, and slightly more companies expected domestic demand to strengthen, or one-fifth. One-third of companies expected profits in 2010 as a share of turnover to be less than in 2009. Executives of export firms were less pessimistic than executives of firms selling in the domestic market.

Inflation expectations one year ahead had fallen. According to an inflation expectations survey conducted by Capacent Gallup in February and March, the median household expects inflation over the next twelve months to be 8%, which is 2 percentage points lower than in the last survey in December. Household inflation expectations have not fallen below 10% in the last two years. Household expectations for inflation two years ahead have increased, however, since the last survey in December. Households now expect inflation to be 6.5% in two years' time, as opposed to roughly 6% in December.

According to the Capacent Gallup business sentiment survey, firms' inflation expectations had decreased since December, with the median company expecting 4% inflation over the next twelve months, compared to 6% in the December survey. Inflation expectations 24 months ahead remained broadly unchanged since the survey in September, with the median company expecting 5% annual inflation in two years' time.

Based on the spread between nominal and index-linked bonds with a three- to four-year maturity, the breakeven inflation rate in the bond market has declined markedly. At the May MPC meeting, the breakeven rate measured 1.7%, as opposed to 2.7% in March. Long-term (five-year/five-year forward) inflation expectations from the bond market have also declined and are now consistent with the inflation target, after rising temporarily during and after the financial crisis.

Annual inflation declined slightly in April, measuring 8.3%, as the CPI rose by 0.25% month-on-month. Underlying inflation, measured by the CPI excluding tax effects, was 6.9% year-on-year. Annualised seasonally adjusted three-month inflation measured 7.2% in April, compared to 7.9% in March.

Domestic goods and services contributed most to inflation in April. Food and beverage prices accounted for 0.17 percentage points of the increase in the CPI, due mainly to a 2.2% increase in agricultural products and vegetables. Prices of private services contributed to 0.1 percentage points, reflecting a roughly 2% increase in phone services and a 0.5% increase in hotel and restaurant services. Prices of various imported goods other than food, beverages and transport items declined in April.

The housing component rose by 0.3%, reflecting a 0.6% increase in housing repair costs and a 1.8% increase in paid rent, whereas owner-imputed rent decreased slightly. The

increase in paid rent is mostly due to the large share of rental contracts that are indexed to inflation.

The Statistics Iceland housing price index for the entire country, published in April, rose by 0.1% from the month before. The housing price index for the greater Reykjavík area, calculated by the Icelandic Property Registry, rose by 0.5%, but adjusted to seasonality it increased by 0.2%. Housing market turnover remains limited.

The updated baseline forecast, published in the 5 May issue of *Monetary Bulletin*, indicates that the contraction in GDP will be one percentage point smaller in 2010 than was forecast in January, or 2½%, with the recently published national accounts showing a somewhat stronger performance in late 2009 and leading indicators suggesting a continuation of that development for the beginning of 2010. On the other hand, the outlook is for recovery to begin in Q3/2010, one quarter later than was forecast in January. The growth outlook for 2011-2012 is similar to that in the January forecast, about 3½% in 2011 and 2% in 2012.

The delay in recovery this year is due in large part to weaker investment than previously assumed, owing primarily to further delays in aluminium and power sector projects, although other business investment will also contract more than was assumed in January. Total investment is projected to contract by just over 10% this year, but as aluminium and power sector projects are expected to commence in 2011, growth in total investment is estimated to approach 25% in 2011. The forecast for 2012, however, is broadly unchanged.

The outlook for private consumption in 2010 has improved since January because of a more advantageous initial position in Q4/2009. It is now estimated that private consumption will grow by just over 1% this year instead of contracting by that amount. The outlook for private consumption in 2011 and 2012 is broadly in line with the January forecast, and assumes that private consumption will grow by 3-4% per year.

Developments in public consumption are projected to be similar to the last forecast. However, new figures from Statistics Iceland suggest that the contraction was considerably more pronounced in 2009 than previous figures indicated. The need for fiscal tightening this year will therefore be slightly less than previously thought, and it is assumed that the resulting leeway will be used to support economic recovery. Indirect tax increases will thus be smaller than projected in January during the forecast horizon.

On the whole, the outlook is for domestic demand to contract somewhat less in 2010 than forecast in January, or by just under 2% rather than nearly 3%. Domestic demand growth is also estimated to be somewhat more in 2011. More robust domestic demand will lead to stronger recovery in imports in 2010 and 2011. A stronger króna and accumulation of inventories following destocking by importers enhance the effect.

The króna had strengthened somewhat since the last *Monetary Bulletin*, and exchange rate developments are currently forecasted to be similar to those in the January forecast, although the króna is expected to be 3% stronger on average than was envisaged then.

A considerable surplus has already emerged in the trade account and the current account balance, excluding accrued interest expenses related to the settlement of banks in winding-up proceedings. A trade surplus of 9-10% of GDP is expected in 2010-2012.

The fall in employment in 2009 is more than was assumed in the January forecast. It is now thought that employment declined by about 10% year-on-year in 2009, whereas the January forecast projected a contraction of 7%. Because employment contracted more than GDP did last year, labour productivity increased by 2½%.

Wage costs on a national accounts basis rose by just under 1% in 2009, as opposed to the 5% envisaged in the January forecast. Unit labour costs therefore contracted slightly instead of the estimated rise of nearly 7% in the January forecast. Greater productivity growth will raise unit labour costs by one percentage point less in 2010 than was assumed in the last forecast. Larger nominal wage rises in the latter part of the forecast period and a somewhat smaller increase in productivity at the end of the period imply that unit labour costs will rise by 4½% in 2012, which is somewhat more than previously anticipated.

Employment is forecast to continue declining until mid-2011. Unemployment is projected to be in line with the January forecast, and will remain high throughout 2010, and begin to taper off early next year.

Inflation was higher than anticipated in January, measuring 7.4% in Q1/2010, as opposed to 7.1%, and the outlook is for inflation to be somewhat higher in Q2 as well. Significant spare capacity and the relative stability of the króna will ensure that underlying inflation will decline rapidly in 2010 and reach the inflation target in Q1/2011, one quarter later than in the January forecast. Headline inflation is forecast at 6.2% in 2010 and about 3% in 2011, and looks set to approach the inflation target towards the end of 2011.

The output slack is forecast to be smaller than assumed in January, peaking in mid-2010 at just under 5% of potential output. As before, the slack is expected to diminish gradually and disappear in early 2013.

II The interest rate decision

The Governor informed the MPC of the results of the Second Review and the IMF Stand-By Arrangement and associated funding, as well as the status of the dispute over compensation to depositors in foreign branches of Landsbanki. The MPC was also informed of the recent steps in the financial sector restructuring process.

The Committee noted that the króna had been broadly unchanged in trade-weighted terms in the onshore market since the last MPC meeting, but had appreciated against the euro without any Central Bank intervention in the FX market. Furthermore, sovereign risk premia had come down, although they were still high due to remaining uncertainty concerning Iceland's medium-term access to global financial markets and possible contagion from the European sovereign debt crisis. In the MPC's view, the króna continued to be supported by the capital controls, more favourable current account developments, and the interest rate differential with major currencies.

As the Committee had expected, inflation picked up in February and March, partly due to unfavourable base effects, but resumed a downward trend in April. Inflation measured 8.3% year-on-year, or 6.9% excluding the impact of higher consumption taxes. Furthermore, the medium-term inflation outlook remained broadly in line with the January forecast, according to the forecast published in the *Monetary Bulletin*

2010/2 on 5 May. As before, underlying inflation is expected to reach the target late this year. The forecast is based on the assumption of a gradually strengthening króna, which is expected to be slightly stronger, on average, in the onshore market over the medium term than in the January forecast. Some members expressed concerns over the risk of second-round effects on inflation from wage pressures caused by rising profitability in the traded goods sector, while one member argued that there was only a modest risk of second-round effects on inflation as long as the unemployment rate remains high.

The MPC noted that, according to the May forecast, growth of fixed investment will be weaker in 2010 due to delays in aluminium sector-related projects and slower recovery of other business investment. On the other hand, private consumption had stabilised at an earlier stage of the cycle, and the output contraction in 2009 had turned out smaller than previously forecast.

The Committee discussed the change in the monetary stance from the March meeting. The change in the real interest rate differed depending on the measure of inflation. The level of restraint had diminished measured by past inflation, stayed broadly unchanged measured by the breakeven inflation rate in the bond market, and increased measured by household and corporate inflation expectations and the inflation forecast published in the 5 May *Monetary Bulletin*. The range was from slightly negative measured by past inflation to around 4% measured by corporate inflation expectations and the breakeven inflation rate in the bond market. The MPC also noted that the risk-adjusted short-term interest rate differential against major currencies had stayed broadly unchanged or decreased slightly since the last MPC meeting, and was currently at 3 percentage points when using the CDS spread as a measure of the risk premium.

Members discussed the possibility of lowering the policy rate by 0.5 to 1.5 percentage points. As before, members agreed that a forecast of reduced inflation in the context of a weak economy was an argument for a reduction in interest rates. Furthermore, since the last MPC meeting, the Second Review of the IMF programme had been approved. Concerns about the Icelandic Government's ability to service its external debt falling due in 2011 and 2012 should therefore be alleviated, and further delay in resolving the Icesave dispute is less likely than before to affect Iceland's credit rating.

The MPC stated, however, that the removal of capital controls, which have shielded the króna from the effects of delays in the past, would be risky until access to further programme financing is guaranteed. The planned liberalisation of capital controls was therefore likely to be delayed until an agreement is in place, or after the Third Review.

The Committee discussed several opposing factors that still called for more cautious steps. The recovery of the króna had been weak since the last interest rate decision. The CDS spread remained high, although it had come down significantly since early in 2010 and was only modestly affected by the turmoil stemming from Greece's fiscal problems. The MPC agreed that, while the credit rating outlook had stabilised, there were still residual uncertainties concerning Iceland's access to global financial markets.

In light of the discussions and the range of views expressed, the Governor proposed a rate cut of 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 7.0% and 8.25%, respectively, the seven-day collateral lending rate to 8.5%, and the overnight lending rate to 10.0%. Although two

MPC members would have preferred to take a larger step this time, all viewed that the difference was small enough to accept the Governor's proposal.

Of the two members wanting to take larger steps, one suggested a rate cut of a 0.75 percentage points, citing a more positive outlook after the completion of the Second Review of the IMF programme, as the financing associated with the Review was secured although he argued that it had not been fully priced in by the markets. With that more fully priced in, the risk adjusted interest rate differential with major currencies would be more than needed to support exchange rate stability. Given that the monetary policy stance was significantly tighter than warranted by inflation prospects and domestic economic conditions, this implied room of manoeuvre could be used for a somewhat bigger cut in interest rates. The other member suggested a 1.0 percentage point cut, emphasising that the real economy, as well as domestic balance sheet restructuring, called for a larger reduction of interest rates. Furthermore, the calculation of real interest rates as the difference between nominal rates and past inflation underestimated the contractionary effect of the monetary policy stance, as measured inflation mainly reflected changes in the price of imports, which were becoming relatively more expensive. This member also argued that the current short-term interest rate differential was unnecessarily large.

As before, the Committee agreed that, if the króna remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. The MPC noted, however, that although the uncertainty about Iceland's future access to foreign capital markets is less than before the Second Review, some uncertainty still exists and will limit the Committee's room for manoeuvre. Furthermore, the MPC agreed that it should stand 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 23 June 2010.