



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

January 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 25 and 26 January 2010, during which the Committee discussed economic and financial market developments, the interest rate decision of 27 January, 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 10 December interest rate decision, as reflected in the updated forecast published in *Monetary Bulletin* 2010/1 on 27 January.

Financial markets

The average trade-weighted value of the króna in the onshore market was 0.5% higher one week before the January MPC meeting than in the week prior to the December meeting. Volume in the foreign exchange market has been low, at 21 m. euros in December and 3 m. euros the first three weeks in January and the Central Bank has not intervened in the market since early November. The króna has appreciated by approximately 2% against the euro since the last MPC meeting, due to the weakening of the euro against other currencies. Residents’ FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

Five certificate of deposit (CD) auctions had been held since the December meeting, and about 48.6 b.kr. worth of CDs were outstanding at the time of the January 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 January meeting. Trading volume in the interbank market was 296 b.kr. in 2009, about one third of 2008 volume. No transactions have occurred in the market so far in 2010.

The króna weakened in the offshore market in mid-December, following a stronger enforcement of the capital controls, trading at 290-300 against the euro. Offshore market demand for krónur has increased in the new year, causing the exchange rate to recover again towards 245-275 against the euro. Turnover appears, nevertheless, to be low.

Risk premia on the Republic of Iceland, as measured by the CDS spread, rose relative to comparators in the beginning of January following the president's decision not to sign the Icesave legislation. At the January meeting the CDS spread had risen by 220 basis points from the beginning of December. The Icelandic Republic's sovereign credit rating also deteriorated in the wake of the president's decision.

The yield in the mid-January Treasury bill auction was 8.0%, compared with 7.5% in the mid-December auction. The yield on T-notes had also risen by 0.14 to 0.30 percentage points from the December meeting. At the same time, the yield on indexed HFF bonds had declined by up to 0.30 percentage points at the shortest maturity, following the president's announcement that he would not sign the Icesave law.

Outlook for the global real economy and international trade

At 6.2 b.kr., the November merchandise trade surplus was similar to the average surplus for the first eleven months of the year. According to preliminary numbers, the trade surplus was somewhat larger in December, or 7 b.kr., due mainly to a decline in imports.

Import values in domestic currency rose by 24% month-on-month in November, owing mainly to an increase in imports of fuels and industrial supplies. The value of exports in domestic currency was almost 6% lower in November than in October, despite a further increase in aluminium prices, as volumes fell.

Aluminium prices have continued to rise since the last MPC meeting and were 7% higher on average in the first half of January than in the first two weeks of December. The value of marine product exports dropped by 6% between November and October as a result of lower export volumes, as the average price of all marine products remained stable month-on-month.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, total hours worked fell by 5½% year-on-year in Q4/2009. The fall in hours worked was due to both a half-hour decline in average weekly hours worked and a drop of nearly 5% in the number of people working during the reference week. Labour market participation fell by 1.2 percentage points in Q4/2009 from the same quarter the year before.

Registered unemployment rose from 7.6% in October to 8.2% in December. Seasonally adjusted unemployment measured 7.7% in December, having fallen by 1.3 percentage points from October, and was less than registered unemployment for the first time since April 2009.

Indicators suggest that the labour market has yet to soften further. According to the Capacent Gallup business sentiment survey, carried out among Iceland's 400 largest firms over a three-week period from 7-18 December 2009, nearly 40% of companies intend to lay off staff in the next six months, while 14% expressed an interest in recruiting staff. Moreover, general labour market sentiment is more pessimistic than in October, according to the Gallup Consumer Sentiment Index. Directorate of Labour figures on new unemployment registrations so far in 2010 indicate that the jobless rate will rise again.

The wage index rose by 1.5% month-on-month in November and by 0.3% in December. Wages increased by 3.6% year-on-year in December, and real wages fell by the same amount.

Payroll taxes were raised by 1.6% on 1 January 2010. Since June 2009, they have been raised from 5.34% to 8.65%.

According to the Capacent Gallup survey of business sentiment that was done in December, roughly 90% of firms considered the current economic situation bleak and were more pessimistic about the outlook six months ahead than they were in September. Around 43% of companies believed that the economic situation would deteriorate in six months' time, compared to about 34% in September. Less than one-fifth of companies expected the economic situation to improve, down from one-fourth of the companies in the September survey.

About 42% of companies expected that domestic demand would decline over the next six months, up from 30% in September, and 17% of companies expected demand to strengthen, as opposed to one-fourth of companies in September. More firms were pessimistic about profits for the next six months, or 83%, up from 56% in September.

Executives of export firms were less pessimistic than executives of firms selling in the domestic market. For the first time since March executives of export firms were more pessimistic about foreign demand than they were in the previous survey, however.

A number of economic indicators, such as payment card and groceries turnover, retail sales, and unemployment suggest that private consumption remained relatively stable between Q3 and Q4/2009 after starting to increase again between Q2 and Q3.

The consumer price index (CPI) decreased by 0.31% in January, or 1.05% excluding indirect tax effects. Annual inflation measured 6.6%, or 5.2% excluding direct tax effects.

The decline in inflation is explained primarily by a stronger-than-usual effect of winter sales, with the total effect amounting to a 0.94% drop in the CPI. Imported goods added a further 0.26% to the decline in the CPI. The cost of owner-occupied housing decreased by 2.9%, causing the CPI to fall by 0.37%. Price increases for public services were smaller than typically found in January, adding 0.23% to the CPI. The effect of indirect tax increases was also somewhat less than anticipated or 0.74%.

The Statistics Iceland housing price index for the entire country, published in January, decreased by 2.7% from the month before. Housing market turnover remains limited.

The updated baseline forecast, published in the 27 January issue of the *Monetary Bulletin*, indicates that while last year's contraction was smaller than previously estimated, the contraction in 2010 will be larger. Recovery will be weaker, due in particular to delays in aluminium and power sector activity.

Inflation will be lower in Q1/2010 but will nonetheless remain higher throughout 2011 than was projected in November, owing to larger rises in unit labour costs, a somewhat weaker króna, and higher inflation expectations.

Uncertainty about the economic outlook has increased because of greater uncertainty about the progress of the economic programme of the Government and the International Monetary Fund (IMF). An important assumption underlying the baseline forecast is that this uncertainty will subside in the near term; otherwise, the outlook is for a slower pick-up in investment, a larger contraction in GDP, and higher unemployment than assumed in the baseline forecast.

II The interest rate decision

The Governor informed the MPC of the status of the Second Review of the IMF Stand-By Arrangement and the status of the dispute over compensation of 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 stable in the onshore market since the last MPC meeting, and indeed since last summer, without any Central Bank intervention since early November. It noted especially that this stability had continued despite internal and external developments that could have been expected to affect the króna negatively, in particular the turmoil caused by the president's decision not to sign the Icesave legislation. In the MPC's view, this reflects the effectiveness of the capital controls, as well as a gradual improvement in the underlying current account balance.

The Committee observed that the failure to resolve the dispute over compensation of depositors had already triggered a sovereign credit rating downgrade to non-investment grade by one of the rating agencies and could delay the Second Review of the IMF programme. Risk premia on the Republic of Iceland, as measured by the CDS spread, had also risen. Consequently, access to bilateral and multilateral financing, a prerequisite for successful access to international capital markets and a sustainable balance of payments outlook, might also be delayed.

MPC members agreed, though, that given the effectiveness of the capital controls, the short-run effect on the króna should be modest, but that further steps towards removing the capital controls would be risky given these uncertainties.

The Committee discussed economic developments and prospects as presented in the forecast published in the *Monetary Bulletin* 2010/1. Inflation had continued to decline in December and January, slightly more than in the November forecast. The 0.3% drop in the CPI in January was unexpected, and while inflation will be lower in the first quarter than was projected in November, it is expected to remain higher throughout 2011 as a result of a somewhat weaker króna, higher unit labour costs, and higher inflation expectations.

The Committee agreed that the pace of disinflation would depend to a large extent on near-term exchange rate movements. Some MPC members argued that there was only a modest risk of second-round effects on inflation as long as the labour market remains weak. Others voiced concerns about rising profitability in the traded goods sector, which they argued could generate wage pressures as soon as the labour market stabilises; however, they envisaged that a gradual appreciation of the króna from its current low level could alleviate such pressures. There were also concerns about a looser fiscal stance compared to previous assumptions and the possible implications of fiscal sustainability on exchange rate and price stability over the longer term.

Although last year's contraction of output was smaller than forecast in November, mostly because of temporary effects, recovery would be weaker due to delays in investments. Uncertainty about the economic outlook had also increased because of greater uncertainty about the progress of the economic programme set forth by the Government and the IMF. The MPC noted that if uncertainty were not resolved soon, the effect could curtail access to international capital markets and reduce the likelihood of new foreign direct investment in the short to medium term. This would lead to less investment and higher unemployment than in the baseline forecast and a larger GDP contraction, as any new investment projects would have to be financed through domestic savings which would only be generated through a larger contraction of private consumption and government expenditure. With the funding of the IMF programme also in doubt, this would also call for the need to generate large current account surpluses in the next few years in order to ensure balance of payments sustainability.

The committee discussed the effects of the changes in outlook since the last rate-setting meeting. With increased risk premia, the current risk-adjusted rates of return on domestic assets had fallen and the incentive for investors to hold or buy króna-denominated assets, calling for higher rates. On the other hand, the bleaker outlook for the real economy and lower inflation called for lower rates.

In light of the discussion, the Governor proposed that Central Bank interest rates be cut by 0.5 percentage points. This implied that the deposit rate (current account rate) and the CD rate would be lowered to 8.0% and 9.25%, respectively, the seven-day collateral lending rate to 9.5%, and the overnight lending rate to 11.0%.

The Governor invited other MPC members to vote on the proposal. Three members voted in favour of the Governor's proposal, while two members voted against it. One of the dissenting members wanted to take a smaller step and cut rates by 0.25 percentage points, arguing that uncertainty had increased and the inflation outlook had deteriorated from the November forecast. The other dissenting member called for unchanged rates. This member argued that uncertainty had escalated following the president's decision not to sign the Icesave legislation, thus lowering the risk-adjusted interest rate differential needed to support the króna. A resolution of that dispute was therefore needed before monetary policy easing could continue.

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. However, the MPC stressed that, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, it 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 meetings.

Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Wednesday 17 March 2010.