SEÐLABANKI ÍSLANDS

MONETARY POLICY COMMITTE E REPORT TO ALTHINGI

2009

Monetary Policy Committee report to Althingi

14 December 2009

The Act on the Central Bank of Iceland stipulates that the Monetary Policy Committee (MPC) of the Central Bank of Iceland shall submit to Althingi 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 MPC meet at least eight times each year. Since the Committee commenced activity on 26 February 2009, it has met nine times. The following report discusses the work of the Committee during the year.

The MPC has adopted rules of procedure that include provisions on how its meetings shall be prepared, how they shall be structured, and in what manner its decisions shall be taken. These rules of procedure are among the documents accompanying this report.

Monetary policy formulation

According to the Act on the Central Bank of Iceland, the principal objective of the monetary policy 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% (the declaration is included with this report). In implementing monetary policy, the MPC bases its decisions in part on an evaluation of the economic status and outlook as it is presented in the Bank's *Monetary Bulletin* (the most recent issue of which is included with this report).

Since the financial and currency crisis struck Iceland full force in 2008, the MPC's main task has been to promote exchange rate stability in accordance with the economic programme agreed by the Government, the Central Bank, and the International Monetary Fund. Among the focal points of that programme has been to protect private sector balance sheets from further deterioration during the economic restructuring and rebuilding phase. A stable exchange rate also contributes towards bringing inflation into line with the inflation target. As economic restructuring progresses, the inflation target will become more important. More detailed discussion of the MPC's rationale can be found in the Committee's statements and meeting minutes, which are included with this report. Included is also a speech held by the Governor at a breakfast meeting of the Iceland Chamber of Commerce, 6 November 2009.

Interest rate and exchange rate developments in 2009

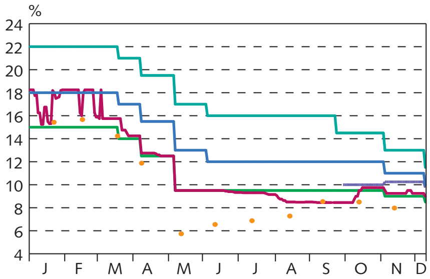
At the beginning of the year, the most important Central Bank interest rate for the development of short-term market rates was 18%.[1]

Table 1. Central Bank of Iceland interest rates 2009 (%)

Date	Current account	28-day CDs	7-day collateral lending rate	Overnight lending rate
10/12	8.50	9.75	10.00	11.50
5/11	9.00	10.25	11.00	13.00
24/9	9.50	10.00	12.00	14.50
13/8	9.50	–	12.00	16.00
2/7	9.50	–	12.00	16.00
4/6	9.50	–	12.00	16.00
7/5	9.50	–	13.00	17.00
8/4	12.50	–	15.50	19.50
19/3	14.00	–	17.00	21.00

1. The Central Bank interest rate that is most important in determining short-term market rates may vary from time to time. For a long while, the Bank's 7-day collateral lending rate was the key determinant of market rates, but since summer 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.

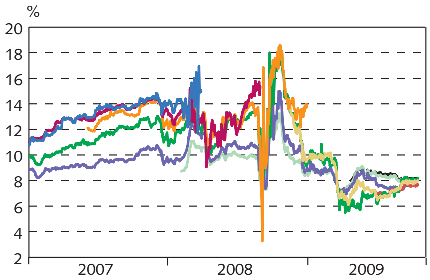
Chart 1
Central Bank and short-term market interest rates
Daily data January 1 - December 10, 2009



Collateral loan rate
O/N REIBOR
Average yield on acccepted bids in auctions[1]
CBI current account rates
Overnight CBI rates
Mid rate on 28-day CDs

1. Because turnover on the secondary market for Treasury bills is limited, only yields in Treasury bill auctions are included.
Source: Central Bank of Iceland.

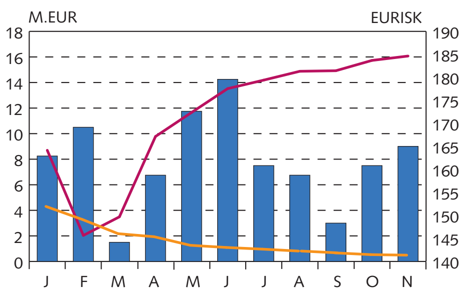
Chart 2
Long-term nominal Treasury bond yields
Daily data January 3, 2007 - December 10, 2009



RIKB 08 0613
RIKB 08 1212
RIKB 09 0612
RIKB 10 0317
RIKB 25 0612
RIKB 13 0517
RIKB 10 1210
RIKB 19 0226
RIKB 11 0722

Source: Central Bank of Iceland.

Chart 3
EURISK exchange rate, exchange rate fluctuations and CBI intervention in the FX market
January - November 2009



CBI intervention (left)
EURISK exchange rate (rigth)
90-day standard deviation of daily changes in the EURISK exchange rate; % (left)

Source: Central Bank of Iceland.

The MPC began lowering interest rates at its first meeting in March 2009, and rates have declined rather quickly since. At present, the Central Bank rate that has greatest impact on short-term interest rate developments is 9.75% (see Chart 1). Short- and long-term market rates have declined in line with Central Bank interest rates (see Charts 1 and 2).

In terms of the trade-weighted exchange rate index, the króna has depreciated by roughly 8% since the beginning of the year. It has fallen by nearly 8% against the euro and roughly 2% against the US dollar. Most of the depreciation occurred in the first half of the year, and since summer the króna has been relatively stable. At the same time, short-term exchange rate volatility has diminished, in spite of reduced foreign exchange market intervention by the Bank (see Chart 3).

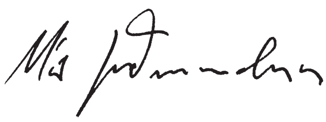
It should be borne in mind that broad-based restrictions on movement of capital to and from Iceland were implemented a year ago. Without these capital controls, the Central Bank would have had to maintain much higher interest rates. The Central Bank has presented a strategy for the gradual, sequenced removal of the capital controls and has already implemented the first phase in the strategy. The Bank's capital account liberalisation strategy and its statement on the first phase in the removal of capital controls are among the documents accompanying this report.

Accompanying documents

The following documents are enclosed with this report:

1. MPC rules of procedure on the preparation of, arguments for, and presentation of monetary policy decisions.
2. Declaration on inflation target issued by the Central Bank of Iceland and the Icelandic Government
3. MPC statements from March 2009 to present.
4. Minutes of MPC meetings from March 2009 to present.[2]
5. Governor's speech at the Chamber of Commerce 6 November 2009.
6. Capital account liberalisation strategy and statement on first phase of removal of capital controls.
7. *Monetary Bulletin 2009/4.*

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



Már Guðmundsson

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

2. The minutes from the MPC December meeting will be published on the Central Banks website on December 23.

April 7, 2009

PROCEDURE OF MPC MEETINGS

Prior to each monetary policy decision:

- MPC (Monetary Policy Committee) members should have access to all relevant data that they need to take an informed decision.
- MPC members should have ample opportunity to exchange views and debate the decision.

To meet these objectives the MPC has agreed to the following meeting structure:

There are at least eight monetary policy decisions each year and there are two types of procedure in the run-up to each monetary policy decision:

- At least four times a year, either when inflation forecasts are changed or when there are significant changes in the macroeconomic environment, regulatory structure or matters related to financial stability, there will be full-fledged procedures consisting of at least three sessions.
- At times there could also be interim decisions based on a more concentrated meeting structure. The concentrated procedure will consist of one to three sessions in a single day. The meeting may be held in person or by teleconference.

The structure of the two types of meetings is detailed below:

Full-fledged MPC meetings

At least three monetary policy sessions shall be concentrated in two days' time. The first session shall take place two days before the policy decision is announced, the second on the morning of the following day and the third in the afternoon of that day.

Session one (two days before announcement)
Attendees: MPC members, secretary of the MPC, key department heads and relevant staff.

Time: At 10:00

Preparation and documentation: Before the regular meetings, staff will present preliminary analysis or draft forecast (prior the publication of *Monetary Bulletin*) and discuss the analysis or forecast in internal meetings of the Governor, Deputy Governor and relevant staff. A final draft of forecasts and/or other relevant documentation and data will be sent to the external members three days before the regular meetings commence.

Topics: The meeting will focus on the economic outlook. Staff members will make short presentations of the relevant data and forecasts to MPC members. Among the topics that should be covered are:

- Market operations (presented by the International and Monetary Operations Department).
- Financial stability (if relevant, presented by the Financial Stability Department).
- Recent economic development and medium-term outlook (presented by the Economics Department).

Session two (one day before announcement)
Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 9:00

Preparation and documentation: The night before the session, MPC members shall receive a draft policy statement (in English) to guide the discussion. After a decision has been made, MPC members can comment on the general orientation of the draft statement.

Topics: This session will focus primarily on the monetary policy decision itself. The Chief Economist will begin by summarising the previous day's presentations. On the basis of that analysis, he or she will make a preliminary suggestion concerning the current policy stance. Subsequently, each MPC member will present his or her view on the general direction of policy. After the first round of discussion, the Governor will suggest a policy decision he or she considers to represent a broad consensus or the majority view of the MPC. The MPC members will then present their own views on the appropriate policy. The Governor will then propose a decision. This will be followed by further deliberation in order to seek a consensus. If there is no consensus, MPC members will vote on the decision.

Session three (one day before announcement)

Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 15:00

Preparation and documentation: Before the session, a second draft of the monetary policy statement will be written, reflecting the decision and discussion in the previous meeting.

Topics: The focus of the session will be the monetary policy statement and related communication. If needed, there could be a recess for further redrafting. After the statement is finalised in English it will be translated into Icelandic.

Interim MPC meetings

When new data or changes in other circumstances since the last MPC meeting do not warrant exhaustive presentation of economic developments and forecasts, monetary policy decisions can be taken on the basis of the following simplified procedure. There will be at least one session, either in person or by teleconference

Attendees: MPC members, Directors of International and Monetary Operations, Financial Stability and IT Departments and the secretary of the MPC.

Time: At 10:00 *(the day before announcement)*

Preparation and documentation: Three days prior to the meeting, MPC members shall receive data and other relevant documentation. One day before the meeting, members will receive a draft of the monetary policy statement.

Topics: The focus of the meeting will be on new data or circumstances since the last monetary policy decision and what these data imply for the policy rate path envisaged at that time. The monetary policy statement shall be shorter, confirming the main points of the previous policy statement and focusing on deviation from the envisaged path. If needed, there could be a recess for redrafting of the statement. After it has been discussed in detail, the final statement in English shall be translated into Icelandic.

Press release and meetings with journalist and analysts

The policy decision will be announced in a press release at 9:00 on the morning on the announcement date (the day after the meeting and policy rate decision), followed by a press conference at 11:00. Analyst from banks, ministries and other relevant economic institutions can also attend this press conference.

Modification of approach

If an MPC member wishes to suggest a change in the above guidelines, he or she should present a proposal in writing to the MPC. After consulting other members of MPC, the Governor will make a decision on whether or not to modify the procedure.

Agenda

The agenda for each meeting is prepared by the Chief Economist subject to the approval of the Governor and the Deputy Governor. It should be submitted to MPC members no later than three days in advance of the first session of each MPC meeting.

Minutes

Minutes of MPC meetings will include a short description of the main arguments put forward, the policy decision proposed by the Governor, the policy decision taken and whether it was unanimous or not. The voting record will be published if the decision is not unanimous. The minutes will be published two weeks after each monetary policy decision.

Communication among MPC members

MPC members are free to voice their opinions concerning the economic outlook and monetary policy, subject to the following guidelines:

- When commenting on monetary policy, MPC members should refrain from commenting on the views of other members of the Committee.
- MPC member should not make public comments on the economic outlook and monetary policy during the last *seven* days prior to the announcement of the policy decision, nor should they discuss this with investors or other parties that might benefit from insider information on the views of MPC

members. These restrictions also include publication of an interview given beforehand.

- MPC members should also avoid making public statements on the day of the announcement.

The same guidelines apply to other CBI officials who participate in MPC meetings.

27 March 2001

Declaration on inflation target and a change in the exchange rate policy

On March 27, 2001 the Prime Minister and the Governors of the Central Bank of Iceland signed a declaration on changes in the framework of monetary policy in Iceland. The declaration is as follows:

The Government of Iceland and the Central Bank of Iceland have decided the following changes in the framework of monetary policy in Iceland, effective March 28, 2001:

(1) The main target of monetary policy will be price stability as defined below. The Central Bank shall also promote financial stability and the main objectives of the economic policy of the Government as long as it does not deem it inconsistent with the Bank's main objective of price stability.

(2) Rather than basing monetary policy on keeping the exchange rate within a fluctuation band, the Central Bank will aim at keeping inflation within defined limits as specified below.

(3) The change described above implies that the fluctuation limits for the króna are abolished. Nevertheless, the exchange rate will continue to be an important indicator in the conduct of monetary policy.

(4) The Government grants full authority to the Central Bank to use its instruments in order to attain the inflation target.

(5) Later this week, the Government will submit to Parliament a bill on a new Central Bank Act which, once enacted, will legally confirm the decisions described above on making price stability the main objective of monetary policy and on the independence of the Central Bank to use its instruments.

(6) The inflation target of the Central Bank will be based on 12-month changes in the consumer price index as calculated by Statistics Iceland. Statistics Iceland will also be asked to calculate one or more indices which may be used to assess the underlying rate of inflation, as will be further agreed between the Central Bank and Statistics Iceland. The Central Bank will take note of such indices in its assessment of inflation and in the implementation of monetary policy.

(7) The Central Bank will aim at an annual inflation rate of about 2½ per cent.

(8) If inflation deviates by more than 1½ percentage point from the target, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank will be obliged to submit a report to the Government explaining the reasons for the deviations from

the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report of the Bank shall be made public.

(9) The Central Bank shall aim at attaining the inflation target of 2½ percent not later than by the end of 2003. In the year 2001, the upper Declaration on inflation target and a change in the exchange rate policy limit for inflation shall be 3½ percentage points above the inflation target but 2 percentage points above it in the year 2002. The lower limit for inflation will always be 1½ percentage point below the inflation target. Should inflation move outside the target range in 2001 and 2002, the Bank shall respond as set out in item 8 above.

(10) Despite the elimination of the fluctuation limits for the króna, the Central Bank will intervene in the foreign exchange market if it deems such action necessary in order to promote the inflation objective described above or if it thinks that exchange rate fluctuations might undermine financial stability.

(11) The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's Monetary Bulletin. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

[Amended text by agreement between the Prime Minister of Iceland and the Board of Governors of the Central Bank of Iceland on November 11, 2005]

(12) The Central Bank shall in its publications explain how successful it is in implementing the inflation target policy. The Governors will also report to the Minister, the Government and committees of the Parliament on the policy of the Bank and its assessment of current economic trends and prospects.

19 March 2009
No. 11/2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Cautious easing of monetary policy is now appropriate

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has voted to lower its policy rate by one percentage point to 17 percent. Economic indicators suggest that conditions for easing are in place. Inflationary pressures have subsided as demand and employment contract and the króna has stabilised. The flexibility of the Icelandic economy has enabled a rapid adjustment of domestic demand, real wages and the trade balance. A large trade deficit has turned to a significant surplus.

The fragility of the balance sheets of businesses, households and banks calls for the stability of the króna. This implies the need for a tighter monetary policy than would be appropriate otherwise.

Over the next few months important steps will be taken in the restructuring and reestablishment of the Icelandic financial system. Once the financial sector restructuring is completed, the overall external and public debt situation and fiscal adjustment is clarified and financial markets become more functional, the ability of monetary policy to support economic recovery over the medium term will be enhanced.

After a one-off adjustment following the depreciation of the króna through 2008, inflation appears to have peaked in January and seems to be declining faster than previously forecast. The outlook is for Q1 inflation to be significantly below the end-January forecast of 18.5 percent and for inflation to return to the 2.5 percent target by early next year. This is supported by the growing slack in the economy as indicated by national accounts data, higher unemployment and other short-term indicators. A weak labour market greatly reduces the risk of second-round effects.

Current monetary policy is guided by the interim objective of stabilising the exchange rate, while the long-term goal remains the inflation target. This is primarily because of the need to protect vulnerable private sector balance sheets during the restructuring phase.

Capital controls support this goal by preventing disorderly capital outflows and protecting foreign currency reserves. These controls will remain in place until it is deemed to be safe to lift them. Considerable uncertainty remains concerning external debt, government financing and financial sector restructuring, and the global environment remains difficult. The preconditions for lifting the capital controls are therefore not yet in place.

Monetary policy decisions are taken with a view towards the eventual abolition of capital controls. Thus, ISK-denominated assets need to continue to offer sufficiently favourable risk-adjusted yields. However, it should be noted that short-term interest rates in the rest of the world have declined significantly since the last monetary policy decision, increasing the interest rate differential between the króna and other currencies, and it appears likely that some easing of monetary policy will not put the stability of the króna at risk. The MPC must proceed with care as it embarks upon a path of monetary easing, with adjustments reflecting improvements in economic stability. In this light, the MPC has scheduled an additional rate-setting meeting and monetary policy announcement for 8 April 2009.

Laying the foundation for a healthy financial system is an essential part of the effort to rebuild the Icelandic economy. It is thus important that the ”new” and ”old” banks are restructured in a timely and appropriate fashion. It is also important that actions are taken by other banks with support from creditors, owners and the authorities to establish a robust capital base. This process should be concluded in a way where the state does not absorb any further private sector losses from the banking crisis.

No. 13/2009
April 8, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Careful easing of monetary policy continues

The Monetary Policy Committee (MPC) has voted to lower the policy rate by 1.5 percentage points to 15.5%. After its meeting in March, the MPC concluded that the conditions for monetary easing were in place. Economic developments since March 19 have been broadly consistent with this view.

As before, monetary policy is guided by the interim objective of stabilising the exchange rate, while the long-term goal remains the inflation target. This is primarily because of the need to protect vulnerable private sector balance sheets during the restructuring phase.

The króna has depreciated by nearly 9% since March 19. The weakness of the króna appears to have been driven by transitory factors, such as relatively large seasonal interest payments on non-resident ISK holdings. While the trade account has moved into surplus, there remains considerable uncertainty concerning the overall current account. Moreover, there is evidence that the capital controls were being circumvented. The authorities have now addressed this problem by closing loopholes in the legislation.

The MPC does not consider it likely that its March 19 decision to lower the policy rate by one percentage point had a significant impact on the króna. The wide interest rate differential between the króna and the major currencies should continue to provide scope for continued 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 increased slightly.

Inflationary pressures have continued to subside. The CPI fell by 0.6% in March, bringing the rate of inflation down from 18.6% in January to 15.2%. The decline in inflation was 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. 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 at a rapid rate and wage pressures remaining subdued. In the MPC's view, recent developments indicate that inflation will continue to fall rapidly, broadly in line with the Central Bank's January forecast. Businesses' inflation expectations have also declined sharply.

The appreciation of the króna in January and February contributed to the benign inflation outcome. The weakness of the króna in March is unlikely to slow down the disinflation process materially, given the sharp contraction of domestic demand. In view of long-term fundamentals, the króna also appears likely to recover from its recent position. Such a recovery is consistent with the view of the MPC during its deliberations in March. Because they prevent disorderly capital outflows, capital controls are an unfortunate but indispensable element of a strategy aimed at protecting balance sheets and promoting a sustainable recovery. 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. While current domestic and external circumstances do not yet allow for the removal of the capital controls without the risk of instability, the Central Bank of Iceland regularly assesses their effectiveness and is exploring possibilities for their gradual, systematic easing as soon as conditions permit.

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

No. 15/2009
May 7, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Monetary easing continues

The Monetary Policy Committee (MPC) has voted to lower the policy rate by 2.5 percentage points to 13.0%.

Economic developments since the last MPC announcement on April 8 have been consistent with the MPC's earlier assessment that the conditions for continued monetary easing are in place.

The interim objective of monetary policy is to stabilise the króna. The króna has been broadly stable since the last MPC meeting, supported primarily by a significant trade surplus. In view of the long-term fundamentals, the króna also appears likely to strengthen from its recent level over the medium to long term. The authorities have addressed problems related to circumvention of the capital controls by closing loopholes in the legislation. The Central Bank is also taking steps to strengthen surveillance and enforcement, in cooperation with the relevant authorities.

Although capital controls are expected to be maintained for some time, the Central Bank is in the process of implementing measures that will enable impatient non-resident investors to unwind their ISK positions while continuing to preserve the Central Bank's foreign currency reserves. Short-term ISK holdings of non-residents are estimated at ISK 200-300 billion. Targeted measures to allow partial conversion should reduce the outflow pressures significantly. A sizeable appreciation in the offshore market occurred recently. These measures should facilitate further convergence of the offshore to the onshore rate.

Inflationary pressures have continued to subside as expected. The year-on-year inflation rate is down from 18.6% in January to 11.9% in April. Over the past few months annualised inflation has fallen even further. The depreciation of the króna since March is not expected to delay the disinflation process to any marked degree, although the April CPI number was slightly higher than expected. Indeed, current projections indicate that inflation will be lower in late 2009 and 2010 than was forecast in January. Inflation will be close to the 2.5% target by early 2010. Due to weaker exports and investment, this year's contraction in domestic demand and output is also expected to be sharper than the January projections indicated.

The MPC furthermore expects that fiscal policy will be tightened by the summer. This implies significant cuts in public expenditure, as well as tax increases and other revenue-enhancing measures that will be implemented in steps towards 2011, re-establishing a balanced primary budget by 2012. This should pave the way for a gradual reduction of general government debt thereafter. In addition to fiscal tightening, the restructuring and normalisation of the operations of the commercial banks will expose borrowers more directly to the cost of funds. This implies a tightening of monetary conditions.

These sizeable contractionary measures, improved stability of the króna, enhanced capital controls, tailored policies to allow the most impatient investors to sell ISK assets in an orderly manner and faster than previously expected disinflation increase the scope for monetary easing, as reflected in today's MPC decision. It is appropriate for the policy mix to shift towards fiscal tightening and monetary easing.

A cautious, yet significant, easing of monetary policy should gradually contribute to economic recovery. Given favourable ISK developments and progress on the fiscal plan, the MPC expects that another significant adjustment of the policy rate can be made following the June MPC meeting, as further elements of the economic programme have been put in place, but expects the pace of adjustments to be more gradual thereafter.

Further clarity about the balance of payments prospects, an approved medium-term fiscal consolidation plan, bilateral and multilateral loan arrangements to supplement foreign reserves and progress in financial sector restructuring are the prerequisites for broad-based easing of capital controls. While current domestic and external circumstances do not yet allow for the dismantling of the capital controls without the risk of serious instability, there has been progress on several fronts that should allow the gradual, systematic easing of controls.

While progress has been made in the area of financial restructuring, action is needed on several fronts in order to re-establish viable commercial banks. Viability requires cost reductions, appropriate downsizing, reducing foreign currency imbalances and exposing borrowers to the true cost of funds. More generally, the banks need to formulate a business plan that makes them profitable. A more transparent and accountable asset management structure needs to be put in place. It is important that the lowering of the policy rate be followed by reduced retail deposits rates, ideally exceeding the policy rate reduction. The next MPC announcement is scheduled for June 4, 2009.

No. 17/2009
June 4, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee:

Continued monetary easing conditional on favourable exchange rate developments

The Monetary Policy Committee (MPC) has voted to lower the policy rate by 1.0 percentage point to 12.0%. The deposit rate will be kept unchanged at 9.5%.

Since early May, market interest rates have fallen significantly. Short-term interest rates have come down by roughly 4 percentage points and longer-term real and nominal rates by 0.5 and 1.5 percentage points, respectively. As a consequence, the yield curve has flattened, prompting investors to shift towards longer-term positions. Furthermore, retail deposit rates have fallen markedly.

In its May 7 statement, the MPC expected further easing of monetary policy conditional on favourable exchange rate developments and progress in fiscal consolidation. Since then the króna has been weak. Although the króna has been supported by a significant trade surplus, it now appears that, due to a deficit on the services account and a significant deterioration in the price of exports, the Q1/2009 surplus was smaller than expected. In addition, the April merchandise trade surplus was relatively small. The Central Bank has intervened to support the króna; nevertheless, net reserves have strengthened somewhat over the last quarter.

While inflationary pressures have been subdued due to weak domestic demand and rising unemployment, significant exchange rate effects are still passed through into the CPI, accounting for most of the 1.1% increase in the CPI in May. An apparently temporary rise in the housing component also contributed to the increase. The year-on-year inflation rate eased from 11.9% in April to 11.6% in May. Given stable exchange rates and continued stability of nominal wages, the disinflation process is expected to continue at broadly the same pace as in the May forecast. Projections indicate that inflation will be close to the 2.5% target by early 2010.

As was stated in May, the MPC considers it appropriate to shift the overall policy stance towards fiscal tightening and monetary easing to the extent allowed by exchange rate stability. The first fiscal policy measures have now been passed by Alþingi. As further measures are implemented, the MPC will assess their impact and their implications for monetary policy decisions. The MPC views a decision on 2009 fiscal measures and a firm commitment on 2010-2012 fiscal consolidation as the cornerstone in re-establishing market credibility and thus allowing further monetary easing.

Finally, it is necessary to take into account the gradual release of capital controls, which is likely to begin late this year. A cautious approach to monetary easing facilitates removal of the capital controls while maintaining the value of the króna. Once balance of payments prospects have been clarified, a medium-term fiscal consolidation plan approved, bilateral and multilateral loan arrangements to supplement foreign reserves concluded, and financial sector restructuring advanced, the first steps can be taken towards easing capital controls by lifting restrictions on new investment. The gradual removal of capital controls will be carried out in a manner conducive to currency stability.

The next MPC announcement is scheduled for Thursday, July 2, 2009.

No. 22/2009
July 2, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Further monetary easing requires a stronger króna

The Monetary Policy Committee (MPC) has voted to keep the policy rate unchanged at 12% and the deposit rate at 9.5%. The decision was motivated by the króna remaining significantly weaker than the level the MPC referred to as acceptable in its March minutes. Inflation and inflation expectations have also risen. Money market liquidity has increased in recent months and market rates have fallen below the policy rate.

The MPC is concerned about maintaining the stability of the króna, both while capital controls are in place and at the time that they are removed. While capital controls are in place, trade flows are a factor in determining the value of the currency. Despite structural improvements in the trade account, a deterioration of the terms of trade and large seasonal interest payments to non-residents have had a negative impact on the current account. Therefore, it becomes even more important to provide sufficient incentive to hold króna assets, bolstering the case against a further interest rate decrease.

The substantial depreciation of the króna since March, along with recent increases in excise taxes, were the main reasons for a 1.4% increase in the CPI in June, bringing the twelve-month inflation rate up to 12.2% from 11.6% in May. Excluding the impact of excise tax hikes, the CPI rose by 1% in June, and by 11.5% year-on-year.

Annualised seasonally adjusted three-month inflation has also increased substantially, measuring 9.5%, or 6.3% adjusted for the increase in indirect taxes, after falling to near zero recently. Inflation in Q2/2009 therefore proved somewhat higher than in the baseline forecast in the May Monetary Bulletin. Second-round effects are expected to be limited, however, due to the unusually weak labour and product markets. A stability pact recently concluded by the social partners extends key wage agreements until 2010, thus further reducing the risk of wage inflation.

Since the last MPC meeting, significant progress has been made on several fronts. First, with the adoption of a medium-term fiscal plan, an important step has been taken towards fiscal consolidation. This should gradually increase the scope for monetary easing, both because it enhances confidence in the sustainability of government finances, making domestic sovereign debt a more attractive asset, even at interest rates lower than the prevailing ones, and because it contributes to a larger trade surplus by reducing domestic demand. Second, financial sector restructuring is proceeding, and the largest banks are to be recapitalised in mid-July. Bank and corporate sector restructuring will also be facilitated by new legislation on the asset management company and the state banking agency. Finally, bilateral loan agreements have now been reached with the other Nordic countries, and the IMF programme is advancing.

The public and external debt situation is close to being clarified, which will likely contribute to reducing risk premia. This will support a gradual removal of capital controls in a manner consistent with a stable króna, starting with a release of new investments. During this phase, the MPC will exercise vigilance concerning the impact of its actions on the exchange rate and inflation. This could imply raising interest rates if conditions warrant it.

The next MPC announcement is scheduled for Thursday, August 13, 2009.

No. 26/2009
August 13, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Further monetary easing requires a stronger króna

The Monetary Policy Committee (MPC) has voted to keep the policy rate unchanged at 12% and the deposit rate unchanged at 9.5%.

The króna has remained stable since the last monetary policy decision, albeit significantly below the level the MPC has referred to as acceptable. Consequently, the disinflation process has slowed down, although inflation is expected to resume a strong downward trend later this year.

With capital controls in place, improvements in the trade account should support the currency. Although temporary factors – e.g., a deterioration of the terms of trade, seasonal interest payments to non-residents, and lately, a seasonal surge in imports – have at various times had a negative impact on the current account and the króna, the absence of a significant intermittent recovery is a matter of concern. There is thus a need to provide sufficient return on króna assets. This will affect both the circumvention of the capital controls and exporters' incentive to convert their foreign exchange earnings into ISK-denominated assets.

Non-residents' ISK positions have declined somewhat in recent months, indicating some circumvention. Businesses also appear to have been building up reserves on their foreign exchange deposit accounts with domestic banks. The build-up of deposits has stabilised in the past few weeks, however. While there is no clear sign that past policy rate reductions have been an important cause of capital control circumvention, accumulation of foreign exchange deposits, or the weakness of the króna in general, such an effect cannot be ruled out. Hence there is a strong case against lowering interest rates further as long as the króna remains as weak as in recent months.

The first step towards the eventual full removal of capital controls – the liberalisation of capital inflows – will probably be taken no later than November 1, according to the liberalisation strategy recently published by the Central Bank. The MPC will avoid any moves that could call into question its overriding commitment to the stability of the króna and low inflation. In this way, monetary policy can contribute to the restoration of confidence that is a prerequisite for the eventual abolition of the capital controls. This could imply raising interest rates if conditions call for it.

As mentioned in previous MPC statements, there has been progress in several areas that are important for building confidence. The Government is firmly committed to a medium-term fiscal plan, bank restructuring is at an advanced stage, and bilateral loan agreements have been negotiated. Once disbursed, the loans should enhance confidence in the ability of the Central Bank to stabilise the króna during the phased removal of capital controls.

There have been some setbacks, however. The First Review of the IMF Stand-by Agreement has been delayed pending Parliamentary ratification of the bilateral negotiations with the UK and the Netherlands, without which other bilateral loan agreements and the foreign exchange swap agreements with the Nordic central banks could be at risk. Iceland has met all other requirements of the programme.

A continuous path of solid disinflation is a key element in restoring confidence in the economy and the currency. After a period of rapidly declining inflation between January and April, disinflation has slowed down or even been temporarily reversed if measured in terms of annualised, seasonally adjusted three-month rates. The depreciation of the króna since March is the main reason for this development.

Notwithstanding a weaker-than-expected króna and rising consumption taxes, that will temporarily increase headline inflation, inflation excluding these tax effects (which is the appropriate reference for conducting monetary policy) is forecast to continue firmly on a declining trend over the next two years. Given the current and prospective slack in goods and labour markets, according to the updated forecast, higher measured inflation is not expected to generate significant second-round effects.

The next MPC announcement is scheduled for Thursday, September 24, 2009.

No. 32/2009
September 24, 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Unchanged monetary policy stance

The Monetary Policy Committee (MPC) has voted to keep the monetary stance unchanged. More precisely, the MPC has decided to keep the collateral loan and deposit rates unchanged at 12% and 9.5%, respectively. However, the Committee has decided to auction 28-day certificates of deposit (CDs) with a minimum bid rate of 9.5% and a maximum of 10%. In addition, the MPC has decided to cut the overnight lending rate from 16% to 14.5%.

Since April 2009, the effective Central Bank rate that governs other short-term interest rates – such as money market and bank deposit rates – has been the Bank's deposit rate, as the banking system has had ample liquidity and has not been borrowing from the Bank. As is previously stated, this rate is currently 9.5%. However, there are indications of excess liquidity in the system at this rate; hence the decision to auction CDs.

The króna has remained broadly stable since the last monetary policy decision on August 13, in spite of a significantly lower level of Central Bank foreign exchange intervention. Foreign exchange market turnover has increased. The króna continues to be weak, however, dampening the disinflation process. Nevertheless, inflation is expected to resume a strong downward trend later this year due to the slack in the economy, thus reducing the risk of significant second-round effects.

There are some encouraging signs. Along with the decreasing need for foreign exchange intervention, the trade surplus has turned out somewhat larger than expected. The business sector's accumulation of foreign exchange deposits at domestic banks has stopped. Export prices have firmed. Moreover, the risk premium on króna-denominated assets continues to decline, as is reflected, for instance, in CDS spreads.

Leakage of the capital controls has been a continuing cause for concern and has contributed to the persistent weakness of the króna. Consequently, the Central Bank has taken steps to strengthen surveillance and enforcement of the controls, in addition to providing sufficient returns on króna assets.

Conditions for the phased removal of the capital controls might soon be in place, provided that bilateral and multilateral financing is secured. Other conditions include continued Government commitment to a sustainable medium-term fiscal plan and well-advanced financial sector restructuring. Broadly speaking, these goals have been met. In this connection, it should be emphasised that the First Review of the IMF Stand-by Agreement will be an important stepping stone for restoring confidence and is a prerequisite for a successful liberalisation of the capital controls. During the transition period, monetary policy will be guided by the interim objective of stabilising the króna.

No. 35//2009
5 November 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Interest rate corridor aligned to the effective monetary policy stance

The Monetary Policy Committee (MPC) has voted to lower the deposit rate (current account rate) by 0.5 percentage points to 9%. The maximum volume at weekly auctions of 28-day certificates of deposit (CDs) will be increased from 25 b.kr. to 30 b.kr., with a minimum bid rate of 9.5% and a maximum of 10.25%. This implies a 0.25 percentage point increase in the maximum interest rate. The seven-day collateral lending rate will be lowered from 12% to 11% and the overnight lending rate from 14.5% to 13%. These rate changes will align the Central Bank interest rate corridor more closely with the effective monetary policy stance, which, before this decision, featured interest rates ranging from 9.5% to 10.0%. The current decision entails an unchanged or slightly easier stance, depending on the volume and rates on CDs in coming weeks.

Measures to drain liquidity from the market by auctioning 28-day CDs, announced after the last MPC meeting, have been successful. Interbank rates have moved within the Central Bank interest rate corridor. This amounted to some tightening of the monetary stance, however, with the effective policy rate remaining below 10%.

The króna has remained broadly stable since late summer, although at a lower value than is desirable.

Central Bank intervention in the foreign exchange market has remained moderate, and the volume is considerably smaller than during the summer. The weakness of the króna may also be somewhat less of a danger to private sector balance sheets, as recent indications suggest that balance sheets are less exposed to foreign exchange risk than previously thought. Ongoing debt restructuring should reduce this exposure further.

The First Review of the Stand-by Agreement with the International Monetary Fund is now complete. This is an important element in restoring confidence and was a prerequisite for the first stage of capital account liberalisation, implemented on 31 October. In accordance with the liberalisation strategy, inflows of foreign currency for new investments are now permitted, and investors are permitted to convert the sales proceeds of new investments into foreign currency. The first-round effect of these measures, if any, should be to support the króna. However, once a stock of new investment has been built up, the impact on the currency could be in either direction. This implies that the exchange rate becomes more sensitive to current and expected monetary policy.

The disinflation process has been slower than anticipated, in large part because the króna has been weaker than previously forecast. Inflation has continued to decline, however, measuring 9.7% year-on-year in October, or 8.8% excluding the impact of higher consumption taxes.

Due to the somewhat weaker currency and slightly smaller contraction in domestic demand, inflation is projected to decline more slowly than previously forecast. Inflation is still expected to fall sharply in 2010, and underlying inflation will be close to target during the latter half of the year. The risk that currency depreciation will result in second-round effects on inflation is moderate. Because inflation is now driven primarily by exchange rate movements, with a small contribution from wage costs and a negative contribution from housing costs, a faster recovery of the króna than is assumed in the forecast would bring inflation down significantly more swiftly than projected.

Provided that the króna remains stable or appreciates and inflation continues to fall as forecast, conditions for further easing of monetary policy should soon be in place. The MPC intends to move cautiously, however, and 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. 38//2009
10 December 2009

Statement of the Central Bank of Iceland Monetary Policy Committee

Gradual monetary easing continues

The Monetary Policy Committee (MPC) has voted to change Central Bank interest rates as follows. The deposit rate (current account rate) will be lowered by 0.5 percentage points to 8.5%. The Central Bank will continue to issue 28-day certificates of deposit (CDs) with a maximum bid rate of 9.75%, which is 0.5 percentage points lower than before. The seven-day collateral lending rate will be lowered by 1 percentage point to 10%, and the overnight lending rate will be lowered by 1.5 percentage points to 11.5%.

In its 5 November statement, the MPC concluded that, if the króna remained stable or appreciated and if inflation continued to fall as forecast, conditions for further monetary easing would soon be in place. The current decision entails some monetary easing, in line with the November statement, and further aligns the Central Bank interest rate corridor with the effective monetary policy stance.

Auctions of 28-day CDs have been successful in draining liquidity from the market. In future, the MPC will decide only the maximum bid rate for the CD auctions in the coming period. On the basis of its liquidity forecast, the Central Bank will then announce the amount of CDs to be auctioned one business day in advance of each auction.

The króna has remained broadly stable since the last MPC meeting, with limited intervention by the Central Bank and no intervention at all since early November. Tighter regulation, enhanced surveillance, and more effective enforcement have made circumvention of the capital controls more difficult. In spite of improved external conditions, significant uncertainty remains concerning short-term capital flows. Foreign exchange intervention policy is intended to smooth out the short-term volatility this could bring to the foreign exchange market.

Inflation continued to decline in November, broadly in line with the latest forecast, measuring 8.6% year-on-year, or 7.7% excluding the impact of higher consumption taxes. The MPC's view is that the risk of second-round effects on inflation is limited and that inflation is driven primarily by exchange rate movements; thus the pace of disinflation will depend mostly on near-term exchange rate movements. If the króna remains stable or appreciates, and if inflation continues to fall as forecast, there should be scope for continued gradual monetary easing. As always, 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, March 2009

Published: April 2, 2009

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 March 17 and 18, 2009, during which the Committee discussed economic developments, the policy rate decision of March 19, and the communication of that decision.

I Economic and monetary developments

During its discussions, the MPC placed emphasis on the following new information that has emerged since the previous interest rate decision on January 29:

Financial markets and the Central Bank of Iceland balance sheet

The effect of a change in the Central Bank's policy rate on the economy is uncertain and probably limited.

The restructuring of the banking sector has proceeded more slowly than was anticipated in January.

Improvements have been made in the liquidity management of the Central Bank, and the IMF criteria for net reserves and liquidity creation are being met.

On December 17, the Central Bank announced measures designed to stimulate interbank market activity. It was decided to widen the corridor between the highest and lowest interest rates on the banks' current accounts with the Central Bank. Trading volume in the interbank market rose immediately afterwards but has fallen again since. Trading volume averaged ISK 2.9 billion in January and ISK 1.8 billion in February, and has totalled ISK 410 million so far in March.

While the data on lending to companies are still limited, the available data indicate that credit creation by deposit money banks (DMBs) is largely non-existent. Deposits with DMBs increased by roughly ISK 250 billion from August to December, due in part to closures of mutual and investment funds (which explains at least ISK 112.5 billion). Pension fund deposits increased by ISK 66 billion. At the same time, however, the possibility of double counting must be kept in mind because a portion of the increase in pension fund deposits is due to investment fund closure.

The króna has been depreciating recently, after appreciating at the beginning of the year. On average, the trade-weighted exchange rate index (TWI) was 18% higher in the second week of March than in the second week of January.

Short-term interest rates in the rest of the world have declined significantly since the monetary policy decision in January, widening the interest rate differential between the króna and other currencies. In mid-March, the three-month interbank interest rate differential against the euro averaged 16.5%, roughly half a percentage point higher than in January. However, this large interest rate differential may partly reflect a high risk premium on Icelandic assets.

There is still considerable uncertainty about the supply of domestic government-guaranteed bonds, and this uncertainty has affected the yields on both nominal and indexed Government-guaranteed bonds.

Yields on long-term indexed bonds have risen and were, on average, 0.3-1.0 percentage points higher in the first two weeks of March than they were in January. The rise is partly explained by reduced demand for HFF bonds, which stems from uncertainty about a temporary statutory amendment permitting pension fund members to withdraw up to ISK one million from Pillar 3 voluntary pension schemes in 2009 and 2010. Lower inflation expectations, a higher risk of deflation and uncertainty about future political actions, such as debt write-off and the magnitude and financing of the credit portfolios transferred to HFF from the commercial banks, have also been affecting yields.

On average, yields on nominal Treasury bonds were 0.2-0.7 percentage points lower during the first two weeks of March than in January, due to expectations of a policy rate reduction and increased demand from foreign investors for the shortest maturities. Forward interest rates implied expectations of a roughly one percentage point interest rate cut at the March meeting, while market participants expected a 0.5-1.5 percentage point cut.

On average, inflation expectations implied by yield spreads between nominal and inflation-indexed government bonds were 3.5 percentage points lower during the first two weeks of March than in January. It is not clear to what extent this is caused by mispricing in the market or improved anchoring of inflation expectations.

Outlook for the global real economy and international trade

The global financial crisis has deepened since the January interest rate decision. Global economic activity is falling, and total output in the advanced economies fell sharply in the fourth quarter of 2008. Consumer price inflation abroad is low, global commodity prices have been falling, and inflation expectations have been on the decline. Key policy rates have been cut aggressively and are approaching zero in many countries. Some central banks have already adopted alternative monetary policy measures, and governments have been implementing a wide range of policy actions in order to stimulate demand and improve the condition and functioning of the financial system.

Growth prospects for Iceland's main business partners have deteriorated. According to *Consensus Forecasts*, output is now projected to contract by 2.6% in 2009, down by 1¾ percentage points from January. In 2010 a gradual recovery is forecast, with growth projected at ¾%.

The outlook for the domestic export sector has deteriorated, as global demand is weaker than was forecast in January. This will have implications for export-driven growth and the overall terms of trade. The negative impact is appearing in lower prices of the main export products. There are also signs of reductions in export volumes, but this may be temporary, as production in the export sector does not appear to be slowing down.

Despite continuing cutbacks in global aluminium production, aluminium prices are projected to be about 8% lower in 2009 than anticipated in January. The nominal value of exported aluminium contracted sharply month-on-month in January, due to lower prices and smaller quantities. The preliminary figures for February tell the same story, even though the competitive advantage of Icelandic producers supports high Icelandic production levels.

New data for the marine sector show that the January forecast was too optimistic. Fish prices fell by about 4% month-on-month in January and have continued to fall in February and March, according to sales personnel. On the other hand, figures for service exports, especially tourism, have been revised upwards for 2009.

The trade balance on goods and services turned into a surplus in the fourth quarter of 2008, and this trend is expected to continue. Underlying trade flows should therefore support the króna over the medium term.

The domestic real economy and inflation

Preliminary quarterly national accounts figures for the Icelandic economy show that the economy was cooling somewhat faster in the latter part of 2008 than the January forecast assumed. In real terms, GDP declined by 1.5% year-on-year in Q4 2008, a contraction similar to that in Q3. For the year as a whole, the preliminary figures show slightly positive GDP growth measuring 0.3%.

Q4 2008 saw a positive change in the balance of trade, due to an almost 50% contraction in imports year-on-year. In 2008, imports fell 18% while exports rose by roughly 7%. Exports of goods increased by about 11%, but service exports fell by 1.3%. The positive contribution of net trade more than offset a 9% contraction in domestic final expenditure, making the growth rate of GDP slightly positive for 2008 as previously mentioned.

While the trade balance turned positive in the fourth quarter of 2008, the current account deficit was considerably larger than in the preceding quarter, due to an extremely large deficit on the income account. In the fourth quarter of 2008, the current account deficit equalled 50% of that quarter's GDP. For the year as a whole, the current account deficit totalled 34% of GDP, compared with a current account deficit of 16% of GDP in 2007. Due to a large negative balance on primary income from abroad, the reduction in gross national income was large, almost 30%.

So far this year, the contraction in demand, as reflected in payment card and groceries turnover and numbers on imported investment goods, is escalating and remains in line with the January forecast. Domestic payment card turnover of individuals contracted by more than 25% in real terms. This follows a contraction of over 20% in the fourth quarter of 2008. From November 2008 to January 2009, expenditure on imported investment goods contracted by 70% compared to the same period a year before.

The 2008 fiscal position came out weaker than expected in January because of lower tax revenue. Public consumption increased by 2.8% instead of 3.5%, and public investment was substantially lower than previously assumed, 1.6% instead of 10.6%.

New labour market figures are in line with the January forecast. Registered unemployment rose from 6.6% in January to 8.2% in February, far above its natural rate. Seasonally adjusted unemployment was 6.7% in February. Since measurements were introduced, unemployment has never been this high or risen this fast.

Real wages were down by 9.4% in January, and in Q4 2008, nominal wages in the private sector fell for the first time, by ½% from the previous quarter.

Preliminary numbers indicate that there were about 10% fewer foreign workers at the end of last year than at mid-year.

The negotiated wage increases that were to take effect in March 2009 have been postponed until July 2009.

The rapid rise in unemployment indicates that a negative output gap has already emerged, one quarter earlier than assumed in January.

Inflationary pressures are disappearing and the inflation outlook is improving somewhat faster than was forecast in January. Headline inflation measured 17.6% in February, down from 18.6% a month earlier. Core inflation may also have peaked in January at 18.5%, as it measured just over 18% in February. Three-month seasonally adjusted annualised inflation was 13% in February, down from almost 19% in January.

The exchange rate pass-through from last year's depreciation appears nearly complete, reflecting the flexibility of the Icelandic economy.

In February, real house prices fell by nearly one-fifth year-on-year, while nominal prices declined by just over 5%.

Simple cost-push models suggest that the CPI will decline by 0.6% in March. Updated forecasts project inflation at 17.5% in Q1 2009 and 12.4% in Q2, one to two percentage points lower than forecast in January. The exchange rate has strengthened somewhat more than expected in the first quarter.

The updated forecast indicates slightly weaker activity during the forecast horizon. National expenditure is expected to be lower in 2009-2012. The contraction in investments will be more pronounced in 2009-2011, partly because of the postponement of the Helguvík aluminium project. There has also been a downward revision of government spending and investment. Imports are projected to fall further and exports are projected to rise in association with reduced demand and a weaker real exchange rate. Despite weaker domestic demand, a lower exchange rate is expected to ensure that the trade balance will keep GDP growth stronger in 2010 than forecast in January but in line with the forecast for the rest of the horizon.

According to the forecast, inflation will be close to the 2.5% target in 2010 instead of 1.5%, as was projected in January.

The outlook is therefore broadly in line with the January forecast: the real economy is adjusting rapidly, reflecting its flexibility. At the same time, inflationary pressures are disappearing quickly, and prices will remain stable as long as the exchange rate remains relatively stable.

II The interest rate decision

The MPC agreed that, while the long-term objective of monetary policy remains the inflation target, the interim objective was the stabilisation of the exchange rate. This was due to the fragility of the balance sheets of households, businesses and banks. Recently, there have been limited market pressures pushing the exchange rate in either direction. The MPC agreed that there were no compelling reasons to aim for an exchange rate level much different from the current one. However, some MPC members argued that although the króna could have reached a temporary equilibrium value from a short to medium-term perspective, the real effective exchange rate was still quite low from a long-term perspective.

The Committee discussed the importance of exchange rate stability in terms of private sector bank and non-bank balance sheets during the ongoing debt restructuring process. Due to unhedged foreign currency exposure, a significant depreciation would jeopardise the balance sheets of households and corporations, while a significant appreciation would weaken the capital base of the new commercial banks, which are long in foreign currency.

The main objective of the capital controls is to protect reserves from a disorderly outflow of non-resident and resident capital. The MPC decided that the conditions for lifting the capital controls were not yet in place, as the global environment remained difficult and there was uncertainty about the level of external debt, government financing, and financial sector restructuring. However, many of these issues are now being worked on, and further clarity is expected in the second quarter of this year.

The Committee agreed that economic indicators suggested that conditions for significant monetary policy easing were in place. The flexibility of the Icelandic economy had enabled a rapid adjustment of domestic demand, real wages and the trade balance.

The MPC observed that inflationary pressures were disappearing and the inflation outlook was improving rapidly, supported by the growing slack in the economy as indicated by national accounts data, higher unemployment and other short-term indicators. After a one-off adjustment following the depreciation of the króna through 2008, inflation appears to have peaked in January and seems to be declining somewhat faster than previously forecast.

All members agreed that a policy rate cut in the range of 0.5 to 1.5 percentage points would be appropriate in view of the possible negative impact of monetary policy easing on the stability of the króna.

Members preferring a relatively small cut argued that the easing cycle should begin with caution due to the great uncertainty concerning the currency market's reaction to an interest rate cut due to limited trading in the markets and the large stock of foreign-owned ISK financial assets. The members noted that, while there was some clarity about the macroeconomic situation, much was unknown about the effect of interest rate changes on exchange rates and the effect of exchange rate changes on private sector balance sheets.

The argument was made that monetary policy decisions should be taken with a view towards the eventual abolition of capital controls and that ISK-denominated assets must continue to offer sufficiently favourable risk-adjusted yields. There is, however, uncertainty about the size of the risk premium.

Furthermore, it was argued that the continued large uncertainty concerning external debt, government financing and financial sector restructuring, and the global environment must be taken into account. However, the members agreed that once financial sector restructuring is completed, the overall external and public debt situation and fiscal adjustment have been clarified, and financial markets have become more functional, the ability of monetary policy to support economic recovery over the medium term will be enhanced.

Although some members argued that it was important to keep a close eye on upcoming CPI numbers, others argued that the CPI numbers were only a reflection of the past exchange rate depreciation and that a cut at the higher end of the range of suggested policy rate changes might be more appropriate, pointing out that any fear of inflation was unwarranted and that the economy had responded remarkably in a short time. Interest rate differentials had also increased since January. The vitality of domestic businesses was also important for the stability of the currency, and the danger was that high interest rates were draining liquidity from businesses and gradually pushing them into insolvency.

The MPC agreed that a gradual approach was justified because of the uncertain relationship between interest rates and exchange rates and the fragility of the balance sheets of businesses, households and banks. It was also noted that the uncertainty surrounding the outlook was unusually pronounced. Therefore, the Committee decided to schedule an additional rate-setting meeting for April 8, 2009. At that meeting, the effects of the present decision could be assessed, and new inflation numbers would be available.

In view of the decision to schedule another meeting in three weeks' time, members agreed that the easing cycle should start with a relatively small step, and the Governor of the Central Bank of Iceland proposed that the policy rate be lowered to 17%.

The Governor invited other MPC members to vote on the proposal. And the MPC voted unanimously in favour.

The Committee agreed on the following interest rate announcement schedule for 2009 but maintained the option of scheduling additional meetings between September and December.

Interest rate announcements and publication dates for *Monetary Bulletin* in 2009		
Date of interest rate decision	*Commentary published in*	*Weeks since previous interest rate decision announcement*
January 29	*Monetary Bulletin* 2009/1 – forecast update	11
March 19	Press release	7
April 8	Press release	3
May 7	*Monetary Bulletin* 2009/2	4
June 4	Press release	4
July 2	Press release	4
August 13	*Monetary Bulletin* 2009/3 – forecast update	6
November 5	*Monetary Bulletin* 2009/4	Interim meetings may be scheduled at a later date

The Committee stressed that laying the foundation for a healthy financial system is an essential part of the effort to rebuild the economy. It argued that it is important that the "new" and "old" banks be restructured in a timely and appropriate fashion. The Committee also found it important that actions be taken by the banks with support from creditors, owners, and the authorities to strengthen the capital base. This process should be carried out so that the State does not absorb any further private sector losses from the banking crisis.

Minutes of the Monetary Policy Committee meeting, April 2009

Published: April 22, 2009

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.

Minutes of the Monetary Policy Committee meeting, May 2009

Published: May 21, 2009

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 May 5 and 6, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of May 7, 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 April 8:

Financial markets

The króna had been broadly stable since the April MPC meeting. The trade-weighted exchange rate index (TWI) was 0.6% higher on May 5 than at the publication of the last MPC statement on April 8.

The spread between the onshore and offshore exchange rates had narrowed again after widening during the first months of the year, with the króna trading at 200 - 210 against the euro on the offshore market, or roughly 23% lower than on the onshore market.

Short-term interest rates in Iceland's main trading partner countries had declined by 1.0 percentage point since the monetary policy decision in April. The spread between the domestic policy rate and the European Central Bank (ECB) policy rate had declined by 2.5 percentage points to 11.7 percentage points. On average, the three-month interbank interest rate differential against the euro was roughly 2 percentage points lower in the first week of May than in the first week of April, although still 11.5 percentage points.

The CDS spread on the Republic of Iceland had declined somewhat. It remained high, at nearly 8%. However, trading is very thin and the CDS-spread is most probably influenced by characteristics of the market instruments, not only country risk considerations.

Volume in the foreign exchange market totalled 1.2 b.kr. in the first week of May, compared to 1 b.kr. in the first week of April; however, these figures reflect the fact that most of the foreign exchange trading of the commercial banks is concluded in-house ever since the interbank foreign exchange market resumed operation in December.

Forward interest rates on nominal Treasury bonds implied that the last policy rate cut was broadly in line with market expectations, as the path shifted downwards while its shape changed only slightly. The downward slope of the interest rate path reflects market expectations of further policy rate easing. The publication of the CPI figures at the end of April did not have any marked effect on indexed HFF bond yields.

Outlook for the global real economy and international trade

The global downturn and lower export prices have had a negative effect on Iceland's export income, which declined by 25% in Q1/2009 from the previous quarter. The trade balance for Q1/2009 was positive by 14.6 b.kr., compared with a surplus of 35 b.kr. in Q4/2008. Including irregular components such as ships and aircraft, the trade balance for Q1/2009 was 13 b.kr. The trade surplus totalled 8.4 b.kr. in March but declined again to 2.3 b.kr. according to preliminary figures for April.

In Q1/2009, the value of imported goods declined by 13% over the previous quarter, with both fuel and industrial supplies import values down by around 20% quarter-on-quarter. Investment goods also posted a modest decline of 4%. Imports of durable consumer goods, which have proven a relatively good leading indicator of changes in private consumption, contracted by 32% quarter-on-quarter, the second quarter in a row.

Aluminium prices peaked in July 2008 but fell sharply thereafter. The downward trend continued during the first two months of 2009, although at a slower pace. In March and April, prices rose again and were near end-2008 levels by the beginning of May.

Reduced demand from Iceland's main business partners has caused prices of the most expensive products to fall markedly in the past few months. Less expensive products have also fallen in price, but not as sharply. Thus marine prices overall were 9.1% lower in Q1/2009 than in Q4/2008.

Marine products and aluminium together constitute 77% of Iceland's total export value. Because of the recent decline in aluminium prices, marine products have again become the largest single export category, accounting for 43% of total export value in Q1/2009, as opposed to 34% for aluminium. The value of exported aluminium declined 38% from Q4/2008 and 17% from Q1/2008, while the value of marine product exports declined by 18% and 12%, respectively, over the same periods.

The domestic real economy and inflation

The Consumer Sentiment Index and its sub-indices rose only slightly in April. Sentiment towards the labour market improved slightly. Sentiment towards the current economic situation remains pessimistic, while expectations about the overall economic situation six months ahead are more upbeat and are similar as in July 2008.

According to the Statistics Iceland Labour Force Survey (LFS), total hours worked fell by over 9% year-on-year in Q1/2009, due to a drop in both the average number of hours worked (-1.9 hours) and the number of people working (-5%) during the reference week. The response to declining demand for labour differs somewhat between core workers (aged 25-54) and the most flexible part of the labour force (aged 16-24).

According to the LFS, 12,700 persons were unemployed and actively looking for work in Q1/2009. This corresponds to 7.1% of the labour force. Unemployment as measured by the Directorate of Labour (DOL) measured 7.5% in Q1/2009.

Registered unemployment totalled 8.9% in March. Seasonally adjusted, registered unemployment was 7.6%, up from 6.7% in February.

In March, the wage index was up 0.1 from the previous month but had risen by 5.5% year-on-year. Real wages were down by 0.7% month-on-month in March and by 8.4% compared to the same month in 2008.

Inflation continued to decline in April. Despite a 0.45% month-on-month increase in the CPI, annual inflation dropped to 11.9%, from 15.2% in March. For the most part, the disinflation is due to base effects, as the 3.4% rise in the CPI in April 2008 disappeared from the twelve-month comparison.

Annualised seasonally adjusted three-month inflation measured 0.8% in April, as opposed to 4.6% in March.

The currency depreciation of the króna since March 12 primarily affected prices of petrol and new motor vehicles in April. Prices of food and beverages declined in April in spite of the weaker exchange rate.

Lower house prices have begun to affect the CPI more strongly. The CPI excluding the housing component rose by 0.8% month-on-month and has increased by 15.6% year-on-year in April. Owner-imputed rent declined by 1.6%, following a roughly 5% fall in March. Owner-imputed rent has fallen roughly 11% year-on-year. Paid rent is still increasing month by month, partially reflecting the fact that a large share of rental contracts are for social housing and are indexed to inflation.

According to a Capacent Gallup survey on inflation expectations, conducted between March 26 and March 31, 2009, households expect inflation to measure 17% over the next twelve months, compared with 14% in a similar survey carried out in October 2008. Inflation expectations have never been so high in this survey. Firms' inflation expectations are much lower, however, at only 0% over the next twelve months, according to another recent Capacent Gallup survey.

Households expect inflation to measure 7% in two years' time. These expectations are unchanged from the October 2008 survey. In comparison, firms expect inflation to measure 4% two years from now.

Households estimate present inflation at 23%, a considerable increase from the March 2009 survey, in which present inflation was estimated at just over 15%. It is also much higher than actual inflation of 15.2% at the time of the survey.

According to the baseline forecast published in the May 7 issue of *Monetary Bulletin*, inflation will be lower in late 2009 and 2010 than was assumed in the baseline forecast in the January issue, but broadly in line with the outlook assumed during the March MPC meeting. Inflation is now projected at 5% year-on-year in Q4/2009 and is expected to approach the 2.5% target early in 2010.

Simple time-series models suggest slower disinflation but are likely to underestimate effects of demand contraction on inflation, inflation expectations, and exchange rate pass-through. The cost-push model forecasts 6% year-on-year inflation in Q4/2009, while a ARIMA model gives a value of 8%.

Due to weaker exports and investment, this year's contraction in domestic demand and output is expected to be sharper than previous projections indicated. The new baseline forecast indicates that the real economy will contract slightly faster and that recovery will be delayed longer than in the updated forecast in March. This is also reflected in the labour market outlook.

The GDP level is forecast to reach a trough in the beginning of 2010, after having fallen 20% from its Q3/2008 peak. Economic activity is expected to pick up in the second half of 2010 and GDP growth to recover to 2½% in 2011.

Primarily because of the postponement of the Helguvík aluminium project from 2009 to 2011, total investment is expected to contract far more in 2009 than was assumed in the January forecast, or by 45%, as opposed to slightly below 30%.

In view of the deteriorating economic outlook, unemployment is expected to peak at around 11% in the first part of 2010 but to decline slower than was assumed in the January forecast.

Real disposable income is forecast to shrink by 15½% in 2009 and remain roughly unchanged in 2010 before rising moderately in 2011. The baseline forecast assumes that fiscal consolidation will give equal weight to spending cuts and tax hikes. Public consumption must therefore contract throughout the forecast horizon, but its share in GDP will nevertheless be above the long-term average for most of the period.

The króna is expected to remain somewhat weaker over the next three years than was forecast in January. This reflects, among other things, the deteriorating outlook for the global economy, which affects the balance of payments outlook. Consequently, the real exchange rate will fall somewhat more in the medium term than was assumed in January.

II The interest rate decision

The Committee reiterated that the current interim objective of monetary policy is to stabilise the króna, while private sector balance sheets are being rebuild.

The Committee agreed that economic developments since the last MPC announcement on April 8 had been consistent with its earlier assessment that the conditions for continued monetary easing are in place. As expected, inflationary pressures had continued to subside. The year-on-year inflation rate dropped from 18.6% in January to 11.9% in April. Annualised three-month seasonally adjusted inflation had fallen even farther over the past few months. The Committee did not expect that the depreciation of the króna since March would delay the disinflation process to any marked degree, although the April CPI number was slightly higher than expected. Current projections indicated that inflation would be lower in late 2009 and 2010 than was assumed in the baseline forecast in the last Bulletin but broadly in line with what was assumed during the March MPC meeting. Inflation was assumed to approach the 2.5% target early in 2010. Due to weaker exports and investment, this year's contraction in domestic demand and output was also expected to be sharper than previous projections indicated. The new baseline forecast indicated that the real economy would contract slightly faster and recovery be delayed compared to the updated forecast in March. This was also reflected in the labour market outlook.

The Committee discussed at length the recent developments in the domestic financial system. The FX-position of the banks was discussed at length. Among issues covered were turnover on the onshore and offshore markets and the importance of FX trading settled within the Banks, the reasons for appreciation of the króna on the offshore market, and the interactions of the policy rate and the exchange rate. The Committee also discussed the CDS market; trading volume and price formation.

The króna had been broadly stable on the onshore market since the last MPC meeting, supported primarily by a significant trade surplus. The Committee agreed that there was no evidence of a negative impact of the policy rate reduction in March and April on the króna. In view of the long-term fundamentals, the króna also appears likely to strengthen from its recent level over the medium to long term. The authorities have addressed problems related to circumvention of the capital controls by closing loopholes in the pertinent legislation.

The Governor discussed the steps the Central Bank is taking to strengthen surveillance and enforcement, in cooperation with the relevant authorities.

The Governor also informed the Committee of the measures the Central Bank is in the process of implementing, which will enable impatient non-resident investors to unwind their ISK positions while preserving the Central Bank's foreign currency reserves. Non-residents' short-term ISK holdings are estimated at 200-300 b.kr. Although capital controls are expected to remain in effect for some time, targeted measures allowing partial conversion should reduce outflow pressures significantly. These measures should facilitate further convergence of the offshore to the onshore rate.

The MPC expected that fiscal policy would be tightened by the summer. This implies significant cuts in public expenditure, as well as tax increases and other revenue-enhancing measures that will be implemented in steps towards 2011, thus re-establishing a balanced primary budget by 2012. This should pave the way for a gradual reduction of general Government debt thereafter. In addition to fiscal tightening, the restructuring and normalisation of the commercial banks' operations will expose borrowers more directly to the true cost of funds. This implies a tightening of monetary conditions. The expected contractionary fiscal measures suggest that it was appropriate for the policy mix to shift towards fiscal tightening and monetary easing.

Committee members agreed that inflation developments and conditions in the real economy supported a further easing of monetary policy. The Committee also agreed that the scope for monetary easing had increased in light of the improved stability of the króna, enhanced capital controls, and tailored policies allowing the most impatient investors to sell ISK assets in an orderly manner.

The MPC argued that further clarity about balance of payments prospects, an approved medium-term fiscal consolidation plan, bilateral and multilateral loan arrangements to supplement foreign reserves, and progress in financial sector restructuring are the prerequisites for broad-based easing of capital controls. While current domestic and external circumstances do not yet allow for the dismantling of the capital controls without the risk of serious instability, there has been progress on several fronts that should allow the gradual, systematic easing of controls.

The MPC discussed a rate cut in the range of 1.5 to 3.5 percentage points. All members agreed that there were arguments for a relatively large step this time but had varying opinions on its exact size. In light of the discussion, the Governor proposed that the policy rate be lowered by 2.5 percentage points to 13.0%.

The Governor invited other MPC members to vote on the proposal. Three MPC members voted in favour of the Governor's proposal. The other two members voted for a 3.0 percentage points cut in the policy rate.

The Committee agreed that cautious yet significant easing of monetary policy would gradually contribute to economic recovery. The MPC expects that further elements of the economic programme will have been put in place by the time the Committee reconvenes in June. Conditional on favourable ISK developments and progress on the fiscal plan, the Committee agreed that another significant adjustment of the policy rate could be made at the June MPC meeting, but anticipates the pace of adjustments to be more gradual thereafter. However, this adjustment could only be made following the publication of a credible fiscal plan.

The Committee argued that, while progress had been made in the area of financial restructuring, action is needed on several fronts in order to re-establish viable commercial banks. This requires cost reductions, downsizing, reducing foreign currency imbalances, and exposing borrowers to the true cost of funds. More generally, the banks need to formulate a business plan that makes them profitable. A more transparent and accountable asset management structure needs to be put in place. The Committee found it important that the lowering of the policy rate be followed by reduced retail deposits rates, ideally exceeding the policy rate reduction.

The following members of the Committee were present:
Svein Harald Øygard, Governor and Chairman of the Committee

Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Anne Sibert, Professor
Gylfi Zoega, professor

In addition, a number of staff participated in the meetings.

Rannveig Sigurðardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, June 4, 2009.

Minutes of the Monetary Policy Committee meeting, June 2009

Published: June 18, 2009

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. The votes of the individual MPC-members will be made public in the Bank's Annual Report.

These are the minutes of the MPC meetings held on June 3, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of June 4, and the communication of that decision.

I Economic and monetary developments

In its discussions, the MPC emphasised the following new information that has emerged since the previous interest rate decision on May 7.

Financial markets

Payments on external loans and outflows associated with large scale investment projects exerted pressure on the króna in the onshore market in the first three weeks of May, but the currency recovered somewhat during the last week of the month. The foreign exchange market is quite thin and large payments can have a significant affect on the exchange rate.

The exchange rate was significantly below the level the MPC had previously considered to be acceptable. In trade-weighted terms, the króna was roughly 0.5% weaker in the first two days of June than it was at the publication of the last MPC statement on May 7. It was almost 7% weaker than was assumed in the baseline forecast for Q2/2009 for the May *Monetary Bulletin*.

Turnover on the foreign exchange market totalled 5.2 b.kr. in May. The Central Bank intervened in support of the króna in mid-May. The Central Bank did not intervene during the last week of May when the króna strengthened somewhat. Despite earlier intervention, net reserves strengthened somewhat over Q2/2009.

The spread between the onshore and offshore exchange rates had narrowed between MPC meetings, with the króna trading at 190-210 against the euro on the offshore market. This must be interpreted with caution, however, as few trades were taking place in the offshore market.

Prices in both the bond market and the CDS market suggest that since the last MPC meeting, the market's assessment of the credit worthiness of the Republic of Iceland had improved somewhat. The CDS market, however, is very thin and reported prices do not necessarily reflect actual trades or committed quotes.

Short-term interest rates in Iceland's main trading partner countries declined by up to ⅓ of a percentage point since the monetary policy decision in May. The spread between the domestic policy rate and the European Central Bank policy rate had narrowed by 2.25 percentage points to 12 percentage points. The three-month interbank interest rate differential against the euro was roughly 1 percentage points lower at the beginning of June than on May 7, although the spread remained sizable at around 6 percentage points.

Since early May, market interest rates have fallen significantly. Short-term interest rates have come down by roughly 4 percentage points and longer-term real and nominal rates by 0.5 and 1.5 percentage points, respectively.

Although rates had already started to decline prior to the last MPC rate decision, a significant share of the decline occurred after the decision. From the publication of the MPC decision on May 7, short-term nominal rates had fallen by roughly 2.4 percentage points while longer-term rates had declined by 0.6 percentage points. The nominal yield curve had therefore become slightly upward-sloping. Real rates had also declined since May 7: by 1.2 percentage points at the shorter end of the yield curve and by 0.2 percentage points at the longer end. The publication of the higher than expected CPI figures in May (see below) did not have much effect on indexed yields, with rates fluctuating around 4%. The real yield curve is now flat after shifting down in the first weeks of May.

With the ample liquidity in the financial system, the Bank's deposit rate appears to be playing a more important role in determining short-term interest rates. Retail deposit rates had also fallen substantially in line with other interest rates.

Outlook for the global real economy and international trade

The external trade surplus was down from 8.4 b.kr. in March to 2.3 b.kr. in April, which is the second-lowest surplus since the balance of trade turned positive last September. Excluding irregular items such as ships and aircraft, the trade balance was 1.9 b.kr in April. The lower April surplus is a result of lower export prices, as the value of imports continued to decline.

In April, the value of imported goods had declined by 0.7% month-on-month and had declined by 50% over the previous year. Only imports of irregular components, such as fuel and industrial supplies, increased in month-on-month terms.

The total value of exported goods amounted to 31.7 b.kr. in April, the lowest since August 2006. This was a result of lower prices for aluminum and fish products, which accounted for 83% of the value of merchandise exports. The month-on-month contraction of exports amounted to 19%, but the year-on-year contraction was 45%. The value of marine product exports declined by 12% month-on-month and 35% year-on-year, while the value of exported aluminium declined by 5% and 23%, respectively, over the same periods, despite volumes remaining robust.

Preliminary figures, based on data from large firms, estimates based on data from 2008 and VAT reports for small and medium-sized firms, indicate a deficit of 2.9 b.kr. for the services account for Q1/2009. This follows deficits of 4.4 b.kr. for Q4/2008. The Q1/2009 deficit is mainly a result of the travel component: transport services had a deficit of almost 4 b.kr., while trade in other services was in balance.

The domestic real economy and inflation

The Consumer Confidence Index decreased by 9 points in May to 29.9. Based on a three-month average, the index has fallen by 60% year-on-year. All sub-indices except the index covering the current economic situation fell in May; sentiment concerning the economic situation in six months decreased the most.

In April, the wage index decreased by 0.2% from the previous month but had risen by 4.5% year-on-year. Real wages were down by 0.6% month-on-month in April and by 6.7% compared to the same month in 2008.

Registered unemployment totalled 9.1% in April, up from 8.9% in March. Seasonally adjusted unemployment increased by 1 percentage point month-on-month to 8.5%.

Prices of residential housing had fallen by 12.1% in May from their peak in October 2007 and by 27.2% in real terms. Turnover is at an historical low; roughly 100 contracts are concluded per month as opposed to almost 1100 at the time when prices reached their peak. The share of housing swaps has increased and amounted to roughly 50% of agreements in the housing market contracts in May.

Year-on-year inflation measured 11.6% in May, decreasing by 0.3 percentage points month-on-month despite the significant month-on-month increase of 1.13%. The CPI excluding the housing component increased by 1.44% month-on-month and has increased by 15.5% year-on-year. Underlying inflation, according to core index 3 (i.e. headline CPI excluding volatile items such as agricultural products and petrol, prices of public services, and mortgage payments costs) was 13.1% over the previous twelve months.

Annualised seasonally adjusted three-month inflation was 1.8% in May, as opposed to 1.2% in April.

The increase in the CPI was mainly due to the recent depreciation of the króna and the lingering effects of last year's depreciation. Higher prices of imported goods accounted for 0.8% of the overall increase. The 1.3% price increase for private services, mainly due to an increase in international airfares, explains just under 0.3% of the CPI increase.

The depreciation of the króna since March 12 affected prices of items which respond rapidly to exchange rate changes, such as petrol and diesel fuel and prices of new motor vehicles, both of which increased by 5% in May. Prices of other items that typically respond more gradually to changes in the exchange rate also rose significantly.

Housing prices rose 1.3% in May. The data can be volatile, but house prices have been declining rapidly in recent months and this rise was unexpected. It is mainly due to a 4.2% increase in housing prices outside Reykjavík and a roughly 2% increase in prices of single-unit dwellings in Reykjavík. Outside Reykjavík, prices have declined by 10.3% year-on-year.

GDP declined by 3.9% between Q1/2008 to Q1/2009, according to the preliminary National Account data released on June 8. This is a smaller decline than was expected in the baseline forecast in the May *Monetary Bulletin*. A 22% decline in domestic demand was nearly offset by a 34% decrease in imports and an 11% increase in exports.

II The interest rate decision

The Committee discussed the financial restructuring and the options that are being considered to address the foreign exchange imbalances of the banks. The state of the domestic financial institutions was also discussed.

The Governor informed the MPC about meetings held with staff from the Ministry of Finance, the social partners and the IMF representative. Staff from the Ministry of Finance presented an outline of the fiscal adjustments planned for 2009-2013 and the options being considered to establish balanced budgets within this timeframe. The social partners presented the status of the ongoing processes, including measures to accelerate the recovery process. The IMF representative presented the Fund's view on the importance of currency stability to stabilise the economy and rebuild balance sheets; continued prudence in reserves management; and easing capital controls in a way that is compatible with supporting the króna.

The Committee observed that, since early May, nominal and real market interest rates had fallen significantly. As a consequence, the nominal and real yield curves have flattened and even turned upward sloping. Furthermore, retail deposit rates had fallen markedly. The nominal yield curve implied that the market had already priced in a roughly 1 percentage point cut in the policy rate. This is also consistent with expectations of most financial market analysts.

The main concern of the MPC was the need to support the value of the króna. This would protect vulnerable private sector balance sheets, reduce pressures on the capital controls and promote a decline in inflation. Members were of the view that significant exchange rate effects from the earlier depreciation were still being passed through into the CPI. This would explain a part of the rise in CPI in May.

The MPC argued that the rise in the housing component that had contributed to the increase in May appeared temporary, since it probably reflects phenomena linked to sampling variability and the increased share of housing swaps. The year-on-year inflation rate had continued to ease in May. Given stable exchange rates and the continued stability of nominal wages, the Committee agreed that the disinflation process would probably continue at broadly the same pace as in the May forecast. Projections continue to indicate that inflation will be close to the 2.5% target by early 2010.

In its May 7 statement, the MPC had anticipated further easing of monetary policy, conditional on favourable exchange rate developments and progress in fiscal consolidation. Since then the króna had been weak in the onshore market. Although the currency had been supported by a significant trade surplus, it appeared that, due to a deficit on the services account and a significant deterioration in the price of exports, the Q1/2009 surplus was smaller than expected. In addition, the April merchandise trade surplus had been relatively small as previously discussed.

As in May, the MPC considered it appropriate to shift the overall policy stance towards fiscal tightening and monetary easing to the extent that was possible without threatening exchange rate stability. The first fiscal policy measures had been passed by Alþingi but some members worried about a lack of a firm political commitment to significant expenditure cuts and tax increases. As further fiscal measures are implemented, the MPC decided to assess their impact and their implications for monetary policy decisions. The MPC viewed a decision on 2009 fiscal measures and a firm commitment on 2010-2012 fiscal consolidation as the cornerstone in re-establishing market credibility and thus allowing further monetary easing.

The main arguments presented for keeping rates unchanged or taking a smaller step this time were the importance of exchange rate stability, both in the short term and in the medium term when capital controls are removed, and the fact that key market rates have come down significantly since early May. A further reduction in the policy rate should thus be preceded by improved exchange rate developments and progress in establishing solid economic fundamentals, including a clear commitment to a credible plan of medium term fiscal consolidation, conclusion of bilateral loan agreements and financial restructuring. Some members particularly stressed that a large rate cut given the weak króna could send an inappropriate signal concerning the MPC's commitment to exchange rate stability, thus exerting further pressure on the exchange rate.

Members emphasised that stronger measures be taken to enforce the capital controls. One member argued that one of the main reasons for the weakening of the exchange rate in May had been increased circumvention of the controls.

The Committee also considered the specifics of easing capital controls. The risk of a premature easing is a sharp depreciation of the króna. The finalising of a sustainable fiscal programme and the completion of the bank restructuring will support an economic recovery and lessen the risk of exchange rate overshooting when the capital controls are removed. Thus, a cautious approach to monetary easing, in association with appropriate fiscal policy, should facilitate the removal of the capital controls while maintaining the value of the króna. Once a medium-term fiscal consolidation plan is under way, bilateral and multilateral loan arrangements to supplement foreign reserves concluded, and financial sector restructuring had advanced, the first steps can be taken towards easing capital controls by lifting restrictions on new investment later this year.

In light of the above discussions, members discussed a potential rate decision in the range of unchanged to lowering the policy rate by 2.0 percentage points and the deposit rate by up to 1.25 percentage points.

The Governor proposed that the policy rate be lowered by 1.0 percentage points to 12.0%. The Governor invited other MPC members to vote on the proposal. Three MPC members voted in favour of the Governor's proposal. The other two members voted for leaving the policy rate unchanged. All members agreed that the deposit rate should be kept unchanged at 9.5%.

The following members of the Committee were present:
Svein Harald Øygard, Governor and Chairman of the Committee
Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Professor Anne Sibert, external member
Professor Gylfi Zoëga, external member

In addition, a number of staff participated in the meetings.

Rannveig Sigurðardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, July 2, 2009.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, July 2009

Published: July 16, 2009

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

These are the minutes of the MPC meetings held on July 1, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of July 2, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, 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 previous interest rate decision on June 4.

Financial markets

The restructuring of the banking system is underway and it is expected that the new banks will be recapitalised by mid-July. Recent legislation on the asset management company and the state banking agency will facilitate both bank and corporate-sector restructuring. However, many problems in the banking system remain unresolved.

Icelandic banks still appear to be hoarding domestic currency and limited trading has been taking place in the interbank market since the MPC meeting in June. This has reduced the MPC's ability to influence short-term market interest rates. On July 1 the Central Bank announced new rules that expanded its authorisation to manage market liquidity. At the same time the Bank tightened the eligibility rules governing collateral at its facilities.

The króna was trading at about 179 against the euro in the onshore market at the end of June. This was 3% lower than at the beginning of the month and is significantly below the rate that the MPC considers acceptable. The Bank intervened in the foreign exchange market in June. On a net basis the reserves of the Bank have, however, improved through Q2 2009.

The spread between the onshore and offshore exchange rates widened after narrowing in previous months. At the end of June, the króna traded at close to 215 against the euro in the offshore market, compared with rates in the range of 190-210 in May. These figures must be viewed with caution, however, as very few trades are taking place in the offshore market. Volume in the onshore foreign exchange market also remained limited in June, amounting to only 6.1 b.kr.

The government has taken some important steps towards bolstering confidence in the króna since the last MPC meeting. A medium-term fiscal plan has been agreed upon, bilateral loan agreements with the other Nordic countries have been approved and the IMF programme is advancing.

The CDS spread on the Republic of Iceland had declined slightly since the beginning of June, but still remained high at 6.5-7.0 percentage points. Trading is very thin, however, and spreads may be influenced by factors other than sovereign risk. The MPC discussed the methodology used to compute the published CDS spreads.

Since the MPC meeting on June 3, interest rates on long-term nominal government bonds have risen by roughly 1 percentage point. Yields on longer government-guarantied indexed HFF bonds, have at the same time risen by 0.25-0.4 percentage points. This combination of a sizable rise in longer-term nominal interest rates and a more moderate increase in longer-term real interest rates could suggest rising long-term inflation expectations. It could also indicate a rise in the inflation risk premium or changes in market liquidity.

Outlook for the global real economy and international trade

In its June 2009 *Economic Outlook*, the OECD has revised upwards its forecast for growth in the OECD economies in 2009-10. This is the first upward revision in two years, but the OECD emphasises that substantial uncertainty exists. The OECD is now predicting that economic growth in OECD economies may be nearing its trough and that it appears that a weak recovery will begin soon and may already be underway in most of the large non-OECD economies. After a collapse in world trade, growth in trade may turn positive by the end of 2009. This is important for Iceland, which will rely on an export-led recovery.

The merchandise trade surplus was 7.4 b.kr. in May. This compares with an April surplus of only 2.3 b.kr. The May surplus is the second-largest one this year. This increase is entirely due to a 19% rise in the value of exports, as imports were little changed since April.

By the end of June, aluminium prices had risen 18% from their low in February. This price rise, coupled with an 8% increase in the quantity of aluminium exports, resulted in an 11% month-on-month increase in the value of aluminium exports. Nevertheless, the value of aluminium exports was down by 50% year-on-year. Marine products accounted for almost half of total merchandise trade exports in May, rising 16% month-on-month. This was due primarily to an increase in quantity, although prices were slightly higher as well.

The domestic real economy and inflation

Real GDP fell by almost 4% year-on-year in Q1/2009: the largest quarterly contraction since quarterly national accounts were first published in 1997. The decline was, however, somewhat smaller than had been forecast in May. This was due to a smaller-than-expected decline in domestic expenditures and more robust exports.

Private consumption fell by 22% year-on-year in Q1/2009. Gross fixed capital formation fell by 52% year-on-year: by far the largest decline in the short history of the national accounts. Of that decline, business sector investment was down by over 57%, residential investment was down by 50% and government fixed investment was down by 40%.

The current account deficit amounted to 49 b.kr. in Q1/2009, or equal to 15% of GDP. Broken down into sub-accounts, there was a 15 b.kr. surplus on merchandise trade, a 3 b.kr. deficit on services and a 59 b.kr. deficit on income. The current account figure was a marked improvement over Q4/2008 when the deficit was 311 b.kr., or 78% of GDP. Most of the difference was due to an improvement in the income account resulting from an upturn in the dividends and reinvested earnings component. The largest component of the income account was the interest payments component, which had a 61 b.kr. deficit. However, as some of these interest payments were obligations of the old banks which will not be paid, this number overstates the cash flow out of the country.

Unemployment was 8.7% in May, 0.4 percentage points lower than in April. This mainly reflects an increase in the labour force in May, with the number of unemployed remaining broadly constant for the past three months. Seasonally adjusted unemployment was also 8.7%, 0.4 percentage points higher than in April.

The wage index rose by 0.2% month-on-month in May, after a 0.2% decline in April. The year-on-year rise was 4.1%. Real wages fell by 1% month-on-month in April and by 6.8% year-on-year.

At the end of June, wage renegotiations were concluded with the signing of the stability pact. Along with increases in wages in 2009 and 2010, it was decided to raise payroll taxes by 1.66 percentage points. As a result, increases in wage costs are higher than was assumed in the May forecast, but the risk of significant wage inflation before the end of 2010 is probably reduced.

According to a Capacent Gallup survey of business sentiment at Iceland's 400 largest companies conducted during May 19-29, 2009, almost 97% of firms consider the current economic situation to be bleak. The small increase in optimism seen in the March survey seems to have faded somewhat. About 55% of firms now expect the economic situation to deteriorate further in the next six months and only 12% of them expect an improvement. About 40% of firms expect that domestic demand will decline over the next six months. Sentiment toward foreign demand has improved since the last survey, however, with 36% of firms now expecting foreign demand to strengthen over the next six months.

The survey suggests that labour market conditions will weaken further, as 35% of firms wanted to lay off workers and only 10% wanted to hire new workers. This compares with 25% of firms wanting to lay off workers and 10% wanting to hire in the March survey.

The Consumer Sentiment index, as well as all of its sub-indices other than the index covering the current economic situation, fell in June. The index measuring expected big-ticket purchases (real estate, motor vehicles and travel abroad) also rose slightly.

Payment card turnover rose during Q2/2009. This might indicate that domestic demand is picking up after plummeting in Q4/2008. The increase during the second quarter could also indicate that payment card turnover is returning to pre-crisis levels after the payment system disturbances that occurred in Q4/2008.

The CPI rose by 1.4% in June. Year-on-year inflation was 12.2%, compared with 11.6% in May. Excluding the effects of recent excise tax hikes, the year-on-year inflation was 11.5% in June. Annualised seasonally adjusted three-month inflation, which had fallen to nearly zero recently, was 9.5% or 6.3% excluding the tax hikes. Year-on-year inflation was 11.9% in Q2/2009 and 11.4% if the tax hikes are excluded. This is somewhat higher than was assumed in the May *Monetary Bulletin* forecast.

A significant share of the rise in inflation in June was due to the depreciation of the króna, with prices of imported goods rising by 22% year-on-year. Higher world oil prices, an increase in taxes on diesel fuel, and a weaker króna pushed up the prices of petrol and oil by 7.8% month-on-month, contributing to a 0.36% rise in the CPI.

The cost-of owner occupied housing declined by 0.8% month-on-month in June. If the housing component is excluded, month-on-month inflation measured at 1.9%, while year-on-year inflation was 16.7%.

According to the Capacent Gallup survey, firms' expectations of inflation remained unchanged from March, with the median firm expecting zero inflation over the next twelve months.

II The interest rate decision

The Governor informed the MPC of recent meetings with the social partners, the IMF representative, and some of Iceland's largest exporters. At the meeting with the social partners, their representatives presented the recently signed stability pact. The Governor told the MPC that he had stated his general support for the pact's objective of accelerating the economic recovery process and his appreciation of the broad consensus achieved in a challenging period that was demonstrated by the agreement, which should reduce the risk of significant wage inflation. However, the Governor emphasised in his meeting with the social partners that the policy rate is set by the MPC in accordance with the Central Bank Act. At the meeting with the IMF representative, the representative expressed the Fund's concerns about the weakness of the króna and emphasised the importance of stabilising the exchange rate. Finally, policies and practices related to the capital controls were discussed with some large exporters. The companies confirmed their commitment to the objectives of the capital control legislation. The Bank's data for most of these large exporting firms showed a robust inflow of foreign currency. However, a change in practices for some firms was warranted and is currently being implemented. This build-up of foreign exchange export earnings, primarily in the domestic commercial banks, could provide important support for the króna in the future.

The Governor described the recently presented fiscal plan as likely to reduce the risk premium on Icelandic government debt and bolster confidence in the króna, thus facilitating monetary easing. He noted the potential positive effects of the progress on bank recapitalisation and the bilateral loan agreements with other Nordic countries but stressed that a resolution of the Icesave dispute is necessary to clarify the public debt situation.

However, while sustainable public finances should contribute to facilitating the removal of the capital controls, the MPC agreed that current conditions do not warrant their easing. The recent weakening of the króna suggests that downward pressure on the currency is still substantial. In the Committee's view the capital controls would still be needed to support the króna for some time, however, a plan for the gradual removal of the controls is being worked on.

The MPC discussed the stock of non-resident ISK positions in the financial system. According to the latest estimates, this has declined from roughly 680 b.kr. in early 2009 to roughly 610 b.kr. in June-end. Long-term holdings have increased slightly, while shorter-term positions have fallen from about 330 b.kr. to 260 b.kr. Although these numbers are somewhat uncertain, they suggest a significant reduction in the possible overhang of non-resident ISK positions.

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

Some MPC members expressed concerns over excess liquidity in the króna market and stressed the importance of improving the Bank's liquidity management. This excess liquidity could be contributing to the weakening of the currency, and it would therefore be important to remove this excess liquidity from the market.

All MPC members expressed concerns over the recent depreciation of the currency. Some expressed concerns that possible circumventions of the capital controls are offsetting the surplus on the trade account. This, together with deteriorating terms of trade and large interest payments in June, has therefore contributed to continuing weakening of the króna in June.

Some MPC members believed that the recent weakening of the króna was not caused by previous rate cuts to any significant extent. However, some members argued that one could not entirely dismiss the possibility that the significant lowering of the policy rate and in particular the policy rate in May could have played a part. Hence, further easing of monetary policy was at this stage viewed as inappropriate until the króna had recovered significantly from its current position. An interest rate hike might even become necessary if the króna does not strengthen within some time.

The MPC also discussed the rise in inflation in June. The factors contributing to this increase were recent indirect tax hikes and the weakening of the króna. With developments in the real economy broadly in line with expectations, it was agreed that limited inflationary pressures were present in the economy. In the Committee's view, the disinflation path towards the inflation target will commence once the exchange rate stabilises.

Some members of the Committee expressed the opinion that monetary policy might have to remain tight for some time to maintain the value of the currency. They were concerned that rising inflation posed the risk of undermining confidence in monetary policy and the króna. The policy rate should not be allowed to fall too low during the disinflation process to avoid further damaging investors' confidence in the currency. The MPC discussed the options of leaving the policy rate unchanged and of increasing it slightly. The possibility of increasing just the deposit rate was also discussed. In light of the discussion, the Governor proposed that the policy rate and deposit rates be left unchanged and the proposal was accepted unanimously.

Although the Committee recognises the progress that has been made regarding fiscal consolidation, as well as the contribution from the social partners, it is the MPC's view that the weak exchange rate precludes further interest rate cuts. However, these factors should bolster confidence in the króna over the medium term and thereby contribute to its appreciation. The Committee also stated that if the króna does not appreciate, it might be necessary to raise interest rates at a later date.

The following members of the Committee were present:
Svein Harald Øygard, Governor and Chairman of the Committee
Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Professor Anne Sibert, external member
Professor Gylfi Zoëga, external member

In addition, a number of staff participated in the meetings.

Adalheidur Ósk Gudlaugsdóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, August 13, 2009.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, August 2009

Published: August 27, 2009

The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set the policy rate and that "[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee's decisions and premises upon which they are based." In accordance with the Act, the MPC has decided to publish the minutes of its policy rate meetings two weeks after each 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 August 11 and 12, 2009, during which the Committee discussed economic and financial market developments, the policy rate decision of August 13, 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 previous interest rate decision on July 2 as reflected in the updated forecast published in *Monetary Bulletin* 2009/3 on August 13.

Financial markets

The króna has been relatively stable since the last MPC meeting, depreciating by 0.8% in July, as opposed to 3.1% in June. The exchange rate in the offshore market has also been broadly stable. The króna was trading at close to 220 against the euro in the offshore market in the beginning of August and in the range from 200-230 against the euro for the last three months. Volume in the FX market has been low over the summer months.

FX intervention by the Central Bank of Iceland was limited in July, amounting to 7.5 million euros, compared to 14.3 million euros in June. Although the Bank's interventions have been sizeable in recent months, they have only been a small share of the total turnover in the market, and remain well within the criteria set out by the Letter of Intent.

Foreign residents' ISK positions have declined somewhat since the beginning of the year, but have been stable the last two months. There has been some movement from short-term positions to longer-term bonds. Some excess liquidity was removed from the system as maturing CD positions were re-invested in Treasury bills. Total reserves positions of the banking system within the Central Bank did not increase even though the Bank stepped down its issuance of CDs and accepted tied deposits, with reserves shifting towards excess reserves.

The amounts that Icelanders hold in FX accounts have stabilised recently, reducing pressure on the króna.

Volume in the interbank market has remained very limited. Price formation in the market seems to be impaired, with the REIBOR rate currently below the Central Bank's deposit rate, at 8.7%. The bond market has, however, deepened in recent month as can be seen in increased trading volume.

Risk premia on the Republic of Iceland, as measured by the CDS spread, have continued to decline. This could be attributable to recent positive developments in Iceland, such as in bank restructuring, the application for EU membership, and the progress made in fiscal consolidation. However, a general decline in risk aversion in global markets could also explain this development.

Outlook for the global real economy and international trade

Although Q2 GDP figures for many countries turned out to be disappointing, leading indicators and, to some extent, actual data suggest that the global recession may be coming to an end and that the recovery is closer in time than previously forecast. Revisions to the outlook on global trade broadly reflect the global outlook revision.

Iceland's trade balance for Q2/2009 was positive in the amount of 18.7 b.kr., broadly similar to the 17.3 b.kr. surplus in Q1/2009, but a marked improvement over the 1.3 b.kr. deficit from a year earlier. The improvement in the trade balance can be attributed primarily to contracting imports, which shrank by 50% year-on-year and 4% quarter-on-quarter. Lower aluminium prices had a pronounced effect on export revenues, with total exports contracting by 40% year-on-year and 2% quarter-on-quarter. Aluminium prices have recently begun to rise again and were almost 9% higher in Q2/2009 than in Q1/2009. The outlook for aluminium prices over the forecast horizon has also improved. This will have important positive effects on the trade balance in the near future. The value of marine products exports declined by 20% year-on-year in Q2, but rose by 9% quarter-on-quarter. According to preliminary numbers, the July trade surplus was 6.4 b.kr.

The domestic real economy and inflation

The Consumer Sentiment Index and all of its sub-indices fell in July. The largest decline was in sentiment towards the economic situation six months ahead, which dropped to a new low.

According to the Statistics Iceland Labour Force Survey (LFS), total hours worked fell by 14% year-on-year in Q2/2009, due to a drop in both the average number of hours worked (2.8 hours) and the number of people working (8%) during the reference week. Male workers in the greater Reykjavík area have been disproportionally hit by the contraction in total hours. Their share of the decline of total hours was 66% while their share of total hours was 35%. Furthermore, the survey shows that a part of the contraction in demand has been met with increased part-time labour.

According to the LFS, 16,600 persons were unemployed and actively looking for work in Q2/2009. This corresponds to 9.1% of the labour force. Unemployment as measured by the Directorate of Labour (DOL) totalled 8.6% in Q2/2009.

Registered unemployment has been falling since April, most likely because the DOL has stepped up its surveillance of those registered. Registered unemployment measured 8.1% in June, 0.6 percentage points lower than in May. Nevertheless, seasonally adjusted unemployment has risen slightly since April, to 8.6% in June.

In June, the wage index was up 0.2 from the previous month but had risen by 3.0% year-on-year. Real wages were down by 1.2% month-on-month in June and by 8.2% compared to the same month in 2008.

Annual inflation subsided further in July, after rising in June. The CPI rose by 0.17% in July. Excluding the 0.6% drop in March 2009 this is the smallest monthly increase since August 2007, bringing the twelve-month inflation rate down to 11.3% from 12.2% in June. Annualised seasonally adjusted three-month inflation was slightly lower or 10.6%.

The Government's decision in June to raise taxes on petrol and diesel fuel had a 0.23% effect on the CPI in July, as the effects were not fully realised in June. Excluding the effects of the tax hike, twelve-month inflation measured 10.4% in July.

The largest contributors to the July decline in twelve-month inflation are the housing component and summer sales. Owner-imputed rent decreased by 2.6% from June due to lower market prices, while prices of clothing and footwear declined by 7.3%. Twelve-month inflation excluding the housing component measured 16.4% in July.

Some exchange rate pass-through is still evident in the CPI, as prices of imported goods rose by roughly 1% between months in July, and by 22.4% in the last twelve months.

According to an inflation expectations survey conducted by Capacent Gallup between May 28 and June 4, households expect inflation to measure 10% in twelve months time, as opposed to 12% in March. This is the same rate as in the survey conducted in June 2008. Inflation expectations peaked at 14% in October 2008.

Household expectations for inflation two years ahead have increased since the last survey in March. Households now expect inflation to measure 7.2% in two years' time, as opposed to 6% in March.

Inflation sentiment has fallen since the March survey. Households estimated current inflation at 12%, as compared with 15.5% in March. Both numbers are in line with actual inflation levels.

The updated baseline forecast published in the August 13 issue of *Monetary Bulletin* indicates that economic activity will be somewhat stronger in 2009 than was previously forecast. The contraction in national expenditure and exports is projected to be smaller than in previous forecasts, about 9% instead of 11%, as forecast in May. On the other hand, the outlook for 2010 has deteriorated, with a 2% contraction instead of the previously projected 1%. The prospects for 2011 have deteriorated as well, with GDP growth at around 1% instead of 2½%, as forecast in May.

The less favourable outlook for GDP in the coming two years compared to the May forecast is explained, firstly, by a sharper contraction in real disposable income, largely because fiscal consolidation will be achieved to a much larger degree through tax increases and lower fiscal transfer payments than was assumed in May. The contraction in private consumption will therefore be greater over the next two years. Secondly, further delays in previously planned aluminium sector investments are assumed, as a result of difficulties in financing energy-intensive projects. Consequently, recovery in overall investment will be delayed beyond what was assumed in May. More robust investment growth in 2011 will, however, counteract this.

In line with a more robust recovery of global demand and a lower real exchange rate, exports, apart from energy-related and marine exports, are projected to grow faster in the next two years than previously expected. Marine exports are however expected to contract in 2009 and 2010 due to quota cuts, and aluminium exports are expected to drop in 2011 due to delays in development projects.

Compared to the May forecast, the contraction in imports will be less in 2009, in line with weaker domestic demand growth, but larger in 2010, owing to weaker domestic demand and a lower real exchange rate. The trade surplus has been revised downwards for 2009 but upwards for 2010 and 2011.

In line with the GDP outlook, the output gap is forecast to be somewhat less negative in 2009 than in the May forecast, or just below 7% instead of 8½%. Unemployment will be broadly in line with the May forecast. Wage costs will be higher, however, mostly due to a 1.66% hike in payroll taxes July 1.

The updated forecast suggested that the inflation outlook has deteriorated somewhat from May. First, the exchange rate has remained weaker than expected in May and the outlook is for a weaker exchange rate throughout the forecast horizon. Second, wage costs are forecast to rise faster than previously assumed. Third, the output slack for this year will be smaller the previously assumed. Fourth, the Government's fiscal consolidation measures will entail sharp rises in indirect taxes in the coming years, which will have a direct impact on headline inflation. The rise in indirect taxes will add nearly 1 percentage point to the CPI in 2009 and about 2 percentages points in each year of 2010 and 2011.

However, disinflation is forecast to continue, albeit at a slower pace, with very limited inflationary pressures in the next few years. A sizeable negative output gap and high unemployment will counteract higher wage costs and a weaker exchange rate and limit any risk of second-round effects emerging. Underlying inflation is therefore expected to reach the inflation target in the middle of next year. A sizeable undershooting of the target is forecast, with temporary deflation not ruled out in late 2010 and 2011. Underlying inflation is however forecast to be close to target by the end of the forecast horizon in the middle of 2012. Headline inflation will, however, be higher or around 4%.

II The interest rate decision

The Committee discussed recent developments in the FX market and the extent of possible circumvention of the capital controls as, for example, suggested by the recent decline in non-residents' ISK position. Businesses also appear to have been building up reserves in their foreign exchange deposit accounts in domestic banks. The accumulation of deposits has stabilised in the past few weeks, however. Moreover, the recently introduced strategy for phased capital account liberalisation was discussed.

The MPC agreed that, with capital controls in place, improvements in the trade account should support the currency. Although temporary factors – e.g., a deterioration in the terms of trade, seasonal interest payments to non-residents, and lately, a seasonal increase in imports – have at various times had a negative impact on the króna, the absence of a significant intermittent recovery is, in the Committee's view, a matter of concern. The Committee therefore agreed on the need to provide sufficient return on króna assets, which would affect both the incentives for circumvention of the capital controls and exporters' incentive to convert their foreign exchange earnings into ISK-denominated assets.

The Committee discussed the inflation outlook. The MPC agreed that a path of solid disinflation is a key element in restoring confidence in the economy and the currency. The MPC noted that the króna had remained stable since the last monetary policy decision, albeit significantly below the level the Committee has referred to as acceptable. After a period of rapidly declining inflation between January and April, the depreciation of the króna since March seems to have slowed down the disinflation process and even led to a temporary reversal if inflation is measured in terms of annualised, seasonally adjusted three-month rates. However, the MPC expects inflation to resume a strong downward trend later this year, in line with the baseline forecast in the *Monetary Bulletin* discussed above.

The Governor informed the MPC of meetings with the IMF representative and the progress of the IMF programme. The Committee also discussed the delay in the First Review of the IMF Stand-by Agreement. The Committee noted that progress has been made on several fronts. A medium-term fiscal plan has been established, bank restructuring is at an advanced stage, and bilateral loan agreements have been negotiated. Iceland has therefore met almost all of the requirements of the IMF programme. However, the delay in ratifying the bilateral negotiations with the UK and the Netherlands government by Parliament has put the other bilateral loan agreements and the foreign exchange swap agreements with the Nordic central banks at risk. This could undermine confidence and delay the whole recovery process, including the plan to remove the capital controls.

The MPC also discussed the state of the domestic financial institutions. The Committee noted that the banks have made some improvements in their liquidity management recently, although the Committee is still concerned over excess liquidity in the króna market and the FX imbalances of the banks. The banks have lowered their deposit rates in recent months, widening the spread between deposit rates and lending rates and increasing their profitability. However, they still appear to be hoarding cash, with credit creation almost non-existent. Competition remains limited.

MPC members agreed that there was a strong case against lowering interest rates further as long as the króna remained at its currently depreciated levels and discussed raising the deposit rate by up to 1.0 percentage point. While, in the Committee's view, there were no clear signs that past policy rate reductions have been an important cause of capital control circumvention, accumulation of foreign exchange deposits, or the weakness of the króna in general, such an effect could not be ruled out. Moreover, the Committee was of the view that further interest rate cuts might not be consistent with the aim to start the liberalisation of capital controls before November 1 2009, especially given the low interbank rates.

Some Committee members noted that while exchange rate stability was an interim goal of monetary policy during the restructuring phase, a low exchange rate was contributing to a recovery based on a switch of demand from imports to domestic products and services, as well as increasing the competitiveness of the export sector, as manifested in an improved trade balance. As a result, some sectors were doing well due to the lower exchange rate.

One member noted that there were no clear signs of domestic inflationary pressures: the observed rise in the CPI was simply capturing the rise in the relative price of imported goods which was aiding the recovery of the domestic economy and improving the trade balance. However, he noted that any sign of mounting inflationary pressures would have to be met forcefully.

The Committee agreed that it should avoid any actions that could call into question its commitment to exchange rate stability and low inflation, particularly in the run-up to the liberalisation of capital movements. In this way, it was argued that monetary policy could best contribute to the restoration of confidence that is a prerequisite for the eventual abolition of the capital controls. This could imply raising interest rates if conditions call for it.

In light of the discussion, the Governor proposed that the policy rate and deposit rates be left unchanged. The proposal was approved unanimously.

The following members of the Committee were present:
Svein Harald Øygard, Governor and Chairman of the Committee
Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Professor Gylfi Zoëga, external member

In addition, a number of staff members participated in the meetings.

Adalheidur Ósk Gudlaugsdóttir and Rannveig Sigurdardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, September 24, 2009.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

September 2009

Published: October 8, 2009

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

The following are the minutes of the MPC meetings held on September 22 and 23, 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of September 24, and the communication of that decision.

I Economic and monetary developments

Before turning to its interest rate decision, the Committee discussed domestic financial markets, financial stability, the outlook for the global economy and Iceland's external trade, the domestic real economy, and inflation, with emphasis on information that has emerged since the previous interest rate decision on August 13.

Financial markets

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

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

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

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

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

Outlook for the global real economy and international trade

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

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

The domestic real economy and inflation

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

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

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

The current account deficit was 46 b.kr. in Q2/2009. Measured as a percentage of GDP, this is one percentage point lower than in Q1, or 12.4%. The deficit is due to a 69.4 b.kr deficit on the income account, which is mainly a result of interest payments related to the "old banks". Most of this interest is accrued, but has not been paid, and therefore does not result in actual payment outflows. Excluding this item, the income account deficit was 36 b.kr. and the current account deficit was 10 b.kr., or 2.8% of GDP. The service account, on the other hand, had a surplus of 7 b.kr. thanks to increased net income from transportation and substantially larger income from tourism. This is the first time in 18 quarters that the service account has been positive. The merchandise trade account had a surplus of 18.4 b.kr in Q2.

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

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

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

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

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

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

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

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

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

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

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

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

II The interest rate decision

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

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

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

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

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

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

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

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

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

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

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

In light of the discussion, the Governor proposed that the collateralised lending rate be cut by 50 basis points to 11.5%, the deposit rate lowered by 25 basis points to 9.25%, and the overnight lending rate lowered by 150 basis points to 14.5%. Furthermore, he proposed that the 28-day CDs be auctioned with a minimum bid rate of 9.5% and a maximum of 10%. The Governor pointed out that this proposal would leave the overall monetary policy stance unchanged, although its composition might be different. Even if the collateral loan and deposit rates were cut, the effective rate would still be 9.5% because of the auction of CDs with a minimum bid rate of 9.5%.

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

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

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

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

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

The following members of the Committee were present:
Már Guðmundsson, Governor and Chairman of the Committee
Arnór Sighvatsson, Deputy Governor
Thórarinn G. Pétursson, Chief Economist
Professor Anne Sibert, external member
Professor Gylfi Zoëga, external member

In addition, a number of staff participated in the meetings.

Rannveig Sigurðardóttir wrote the Minutes.

The next Monetary Policy Committee announcement is scheduled for Thursday, November 5, 2009.

The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting

November 2009

Published: 19 November 2009

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 November 2009, during which the Committee discussed economic and financial market developments, the interest rate decision of 5 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 previous interest rate decision on 24 September, and estimation of the economic conditions in the baseline forecast and alternative scenarios published in the *Monetary Bulletin* 2009/4 on 5 November.

Financial markets

The króna has been relatively stable since the last MPC meeting, depreciating by 0.8% in trade weighted terms between September and October monthly averages, after a 0.5% appreciation in September. At the same time, foreign exchange market intervention by the Central Bank of Iceland had remained moderate. Furthermore, residents' FX account balances at domestic banks have remained fairly stable since the last MPC meeting.

The króna had been trading at close to 200 against the euro in the offshore market following the September meeting, but in the last few days before the November meeting it depreciated to 217, which is close to its level at the time of the September meeting.

At its September meeting, the MPC decided to begin weekly issuance of 28-day certificates of deposit (CDs) to absorb liquidity from the market. Six auctions were held since the September meeting, and about 45.4 b.kr. worth of CDs were outstanding at the time of the November meeting.

After these measures were adopted, interbank market rates rose and aligned with the Central Bank's deposit rate, but the banks' retail deposit rates did not rise correspondingly. Overnight interbank market trading resumed, although volumes were still limited.

Treasury bill yields also moved towards the Central Bank deposit rate in the mid-October Treasury auction. Short-term bond yields have also increased by roughly 0.6 percentage points. Yields on longer-term bonds have however declined since the September meeting by up to 0.2 percentage points. The yield curve has therefore flattened. Long-term real rates have also fallen by about 0.1-0.2 percentage points since the September meeting, depending on maturity.

Risk premia on the Republic of Iceland, as measured by the CDS spread, remained broadly unchanged since the September meeting, ending at roughly 3.5 percentage points, which is its lowest level since mid-September 2008. However, the developments of the CDS spread should be interpreted with caution, as they may be based on limited trading.

Outlook for the global real economy and international trade

International trade has continued to shrink along with the global contraction in consumption and investment and the rundown of inventories. Despite signs of recovery, international forecasts assume that international trade will shrink by roughly 9% this year (compared to 13% in the previous forecast), with the contraction to continue well into 2010. Nevertheless, in Iceland the merchandise trade surplus was 3.1 b.kr. in September, following a 12.5 b.kr. surplus in August. According to preliminary numbers, the October trade surplus was 16.4 b.kr, the largest this year. The merchandise trade surplus in Q3/2009 was 15.9 b.kr. and the combined surplus for the first nine months of the year was 46.4 b.kr., a substantial reversal from the 79.1 b.kr. deficit for the same period last year.

Nominal exports in domestic currency were little changed between August and September, falling by 0.3%, while nominal imports increased significantly in September, mainly due to a substantial increase in imports of fuels and industrial supplies.

Nominal exports in domestic currency of marine products rose in August and September. However, nominal marine exports have contracted by 9% year-on-year, in the first nine months of the year.

Aluminium prices, which had been rising since February, peaked in mid-August at their highest level since November 2008. Prices fell back again in September by around 5%. The effects of this could be clearly seen in the export value of aluminium, which increased by 26% month-on-month in August but contracted by 12% in September. Aluminium prices have inched upward again in October and are, on average, somewhat higher than in September.

The domestic real economy and inflation

According to the Statistics Iceland labour force survey, total hours worked fell by 14% year-on-year in Q3/2009. The fall in hours worked was due to both a three-hour decline in average weekly hours worked and a drop of nearly 9% in the number of people working during the reference week. Labour market participation in Q3/2009 was about 2 percentage points below the Q3 participation rate for the last three years.

Registered unemployment has been falling since April, probably because the Directorate of Labour has stepped up its surveillance of those registered. Registered unemployment measured 7.2% in September, 0.5 percentage points lower than in August. Nevertheless, seasonally adjusted unemployment has risen since last autumn, to 9.4% in September, increasing by 0.4 percentage points month-on-month. Registered unemployment was 7.6% in Q3/2009, and the seasonally adjusted rate was 9.1%.

The results of the Capacent Gallup survey of business sentiment at Iceland’s 400 largest companies, conducted over a three-week period from 8-29 September 2009, indicate that labour market conditions will weaken further, although companies, particularly exporters of goods and services, are more upbeat than in a comparable survey conducted in May. Companies intending to shed staff in the next six months still outnumber those wanting to recruit. Just under one-fourth of companies intend to lay off staff in the next six months, while one-fifth expressed an interest in recruiting staff.

The results of an early October survey carried out by the Confederation of Icelandic Employers (SA) are similar to those of the Capacent Gallup survey. One-fourth of private-sector companies surveyed intend to cut staffing levels in the next six months, while 14% intend to recruit. SA estimates that these results correspond to a net increase in private sector unemployment of about 2 thousand persons over the next six months, which would raise unemployment by just over 1 percentage point.

In September, the wage index was up 0.25% from the previous month and had risen by 1.9% year-on-year. In Q3/2009, the index rose by 0.7% from the previous quarter and by 2.3% year-on-year. Real wages were down by 0.5% month-on-month in September, and by 8% compared to the same month in 2008. Real wages have fallen by 12% since they began to decline in March 2008.

According to the Capacent Gallup survey of business sentiment, almost 95% of firms consider the current economic situation to be bleak. However, executives are more optimistic about the economic situation six months ahead than they were in May. Around one-fourth of companies now expect the economic situation to improve, as opposed to 12% of the companies in the May survey; a third believe it will deteriorate, compared to about 55% in May. Over 60% of companies anticipate an improvement twelve months ahead.

About 30% of companies expect domestic demand to decline over the next six months, down from 40% in May, and 24% of companies expect demand to strengthen, as opposed to 19% in May. The survey results indicate that export firms are more optimistic about foreign demand compared to the March survey.

The Capacent Gallup survey of business sentiment suggests that the output slack may be about to stop growing. Increasing number of firms reported labour shortages (14% compared to 10% in the previous survey) and potential difficulties in meeting an unexpected increase in demand (29%, but 24% previously). These numbers are low, but because they have been on the rise since the beginning of the year, they could imply that capacity utilisation has improved.

The survey results indicate that nominal business investment could contract by more than 44% in 2009 and by about one-fifth in 2010, which is a substantial change from the March survey, when expected investment expenditure was assumed to increase by 62% in 2010.

The Central Bank's evaluation of the status of companies, which is based on information received from credit institutions on the status of domestic businesses' loans and deposits as of end-June 2009, shows that 70% of loans to the business sector are denominated in foreign currency. However, more than half of businesses have no foreign currency debt. These tend to be the smaller companies.

A large portion of loans to businesses will mature in the next four years. Over one-fourth of these loans have maturities that are shorter than one year, and if they are extended, most likely some of the foreign currency loans will be converted to krónur, as access to foreign borrowing is currently very limited and the Central Bank's Rules on Foreign Exchange only allow extension of foreign-currency loans if other terms and conditions remain unchanged.

An estimated one-fourth of businesses are in default. This probably understates the severity of the situation, however, as one-third of business loans are bullet loans, and defaults on bullet loans seldom become apparent before maturity as they typically pay no interest until then.

New Statistics Iceland data on disposable income indicate that households were better prepared to deal with the shock than previously thought. Real disposable income is now considered to have grown marginally in 2008, while the previous estimate suggested a contraction of more than 7%. The main reason for this revision was a re-estimation of financial income.

The year-on-year rate of contraction in payment card turnover in Q3/2009 was 13%, significantly lower than in the previous three quarters. Seasonally adjusted payment card turnover decreased quarter-on-quarter by 1% in Q3/2009, about the same as it did in Q2. Credit card turnover contracted by over 2% in Q3/2009, after having dropped by over 4% in Q2/2009. On the other hand, debit card turnover rose by 2% in both Q3/2009 and Q2/2009, after having declined by 2% in the first quarter.

Nearly 40 thousand individuals had requested pension fund payouts from third-pillar private pension savings as of mid-October 2009. The total amount of approved payouts was around 24 b.kr. before taxes, or about 1½% of GDP.

The index for residential housing prices rose marginally month-on-month in September and October, after declining in the previous few months. In October, prices of apartment houses in Reykjavik, where turnover is greatest, fell but prices of single-unit dwellings and prices in regional Iceland rose. The overall price increase in September and October may, therefore, reflect measurement problems associated with low turnover, rather than a turnaround in the housing market.

The Consumer Sentiment Index rose in September and October, as did all of its sub-indices other than the index covering the current economic situation. The index measuring expected big-ticket purchases (real estate, motor vehicles, and travel abroad) rose slightly but has remained fairly stable at low levels throughout 2009.

Annual inflation continued to decline in October. The CPI rose by 1.14% in October, bringing the twelve-month inflation rate down to 9.7%, from 10.8% in September. Excluding the effects of recent excise tax hikes, year-on-year inflation was 8.8% in October. Annualised seasonally adjusted three-month inflation was 9.3%, up from 7.9% in September.

Year-on-year inflation was 11.0% in Q3/2009 or 10.1% if the effects of indirect taxes are excluded. This is somewhat higher than predicted in the August *Monetary Bulletin* and is explained primarily by the weaker króna. Of the 1.14% rise in the CPI in October, 0.4% is due to imported goods prices. The transitory rise in the overall housing component of the CPI in October, discussed above, accounted for 0.26% of the increase in the CPI. The remainder, nearly a half of the rise in the headline index, mainly stems from developments in the prices of general services and domestic goods excluding agricultural products.

According to an inflation expectations survey conducted by Capacent Gallup between 25 August and 10 September, households' beliefs about current inflation and their expectation of inflation over the next twelve months are unchanged from the previous survey in June. The median household estimated current inflation at 12% and expects it to be 10% over the next twelve months. Household expectations for inflation two years ahead have decreased however since the last survey in June. Households now expect inflation to be 6% in two years' time, as opposed to roughly 7% in June.

According to the Capacent Gallup survey, firms' expectations of inflation have increased since June, with the median company expecting 4% inflation over the next twelve months and inflation of 4% in two years time. This compares with the May survey where the median firm expected zero inflation over the next twelve months and zero inflation in two years time.

The updated baseline forecast, published in the 5 November issue of the *Monetary Bulletin*, indicates that economic activity will be somewhat stronger in 2009 than was previously forecast and economic recovery will be somewhat faster. Seasonally adjusted quarterly output growth is forecast to turn positive as early as Q1/2010. Modest growth is projected for 2011 and 2012. According to the forecast, the contraction in domestic demand will be just under 20% in 2009, but because of a positive contribution from external trade, mainly as a result of import compression, the contraction in GDP will be much less or about 8½%.

The labour market will take longer to turn around than output will. Unemployment is projected to be lower than forecast in August but to continue rising well into 2010, when it will peak at approximately 10% instead of 11% in the August forecast.

Despite higher income taxes in the current forecast than in the August forecast, the outlook for consumption has improved somewhat since August, with a 16% contraction expected this year (as opposed to 20% in August) and a stronger recovery over the forecast horizon. Apart from a slightly brighter overall economic outlook and lower unemployment, the main reasons for the improvement are the previously mentioned revision of real disposable income data for 2008 and the effects of the private pension payouts on consumption.

The recovery in investment will be slower to materialise than was assumed in August, primarily because of the postponement of aluminium and power sector investment. Other business investment will be limited for some time.

The economic outlook has improved in Iceland's main trading partner countries. As a result, the outlook for Icelandic exports is brighter than it was in August. Exports of goods and services are expected to increase by 1½% per year in 2009 and 2010. The low real exchange rate and the global economic recovery will support robust export growth in 2011-12. Against this is a smaller contraction in imports. Compared to the August forecast, the contraction in imports will be less in 2009 and 2010, in line with stronger domestic demand growth. The surplus on trade in goods and services has been revised downwards for this year and in 2010. It is now estimated at nearly 7% of GDP for 2009, over 10% for 2010, and about 12-13% for 2011-12.

Next year's contraction of disposable income will be larger than previously predicted, mostly because of additional direct tax increases. The above-mentioned revision of the income data for 2008, however, implies that disposable income will decline from a higher level and will therefore fall to roughly the same level as in the August forecast.

The central government budget bill for 2010 emphasises revenue generation through direct rather than indirect taxes, in contrast with the assumptions used to prepare the August forecast. The effects of indirect tax hikes on CPI inflation will therefore be less in 2009 and 2010, but more pronounced in 2011.

The output slack is forecast to be smaller throughout the forecast horizon than was predicted in August. It will peak in Q2/2010, and is expected to close in early 2012.

Unit labour costs will rise somewhat this year even though nominal wage growth will be more modest than in previous years because productivity has fallen and the payroll tax has been raised. Unit labour costs is forecast to rise less markedly in 2010-2012 because rising productivity will offset nominal wage increases after new wage agreements are concluded.

A weaker exchange rate and a stronger economy suggest that the inflation outlook has deteriorated somewhat from the levels forecast in August. Underlying inflation, i.e. inflation excluding the effects of indirect taxes, will nonetheless approach the inflation target in the latter half of 2010, and headline inflation is projected to reach the target less than a year later. The forecast assumes a prolonged period of underlying inflation below target. Underlying inflation will be close to target, however, by the end of the forecast horizon.

II The interest rate decision

The Governor discussed progress made since the September meeting. He gave an account of the Icelandic delegation's meetings with IMF representatives, and his meetings with government representatives and financial institutions at the International Monetary Fund's (IMF) Annual Meeting in Istanbul. Also discussed were the recently completed First Review of the economic programme supported by the IMF Stand-By-Arrangement; the first phase of capital account liberalisation, implemented on 31 October; the status of the ongoing Icesave discussions; the recently passed legislation on temporary measures to assist indebted households and businesses; the status of the budget for 2010; and the recently extended 2008 wage agreement to end-2010.

The Committee agreed on the importance of this progress for the future monetary stance. Members saw the First Review of the Stand-by Agreement with the IMF as an important element in restoring confidence and supporting the króna. It had also been a prerequisite for the first stage of capital account liberalisation. It was noted that once a stock of new investment has been built up the exchange rate could become more sensitive to current and expected monetary policy decisions.

In the view of most MPC members, the current risk-adjusted rates of return on domestic assets should offer sufficient incentive for investors to hold or buy króna-denominated assets in the current external environment. Hence, given the outlook for improved fundamentals and in view of declining risk premia in global capital markets, the outlook for the króna may be becoming more favourable.

In the MPC's opinion, the passage of the 2010 Budget should also help to boost confidence in the króna and the economy, as this will ensure a sustainable fiscal programme.

The Committee discussed recent steps in the financial sector restructuring process and the Central Bank's newly published *Financial Stability* report. Particular attention was given to the results of the Bank's evaluation of the status of domestic businesses' loans and deposits, which indicates that corporate sector balance sheets may be less exposed to foreign exchange risk than previously thought.

The MPC noted that the króna has remained broadly stable since late summer, although at a lower value than the Committee considered desirable. Central Bank intervention in the foreign exchange market has remained moderate, and intervention by the Bank is considerably smaller than during the summer. The króna has, however, been weaker than previously forecast. The disinflation process had therefore been somewhat slower than anticipated, although inflation had continued to decline. The forecast published in the 5 November *Monetary Bulletin* showed that, due to the somewhat weaker currency and slightly smaller contraction in domestic demand, inflation would decline more slowly than was forecast in August. Inflation is still expected to fall sharply in 2010, and underlying inflation will be close to target during the latter half of the year.

MPC members agreed that there was only a moderate risk that currency depreciation would generate second-round effects on inflation, either through wages or the prices of domestically produced goods. Furthermore, as inflation is now driven primarily by weaker exchange rate, with a small contribution from wages and a negative contribution from house prices, a speedier recovery of the króna than is assumed in the forecast would bring inflation down faster than projected.

Some members, however, expressed concerns over the substantial share of domestic goods and other services in inflation, which indicated that the contraction in demand appeared to have been insufficient to prevent the currency depreciation from passing through to the price of non-tradables. One member pointed out that the experience from past financial crises showed that the risk of sustained inflation was limited because of the large slack that emerges in the labour market. That member emphasised that current inflation mainly reflected relative price adjustments that did not call for monetary policy responses aimed at stabilising inflation.

Some members emphasised that the low real exchange rate was helping the tradable goods sectors by raising the relative price of its output. This was dampening the fall in overall demand for domestic goods and services and improving operating conditions of the tradable goods sectors. Other members, however, also pointed out the possible distortions that might develop if the real exchange rate were to remain too low for a prolonged period, as resources might be shifted to the traded goods sector in greater amounts than are sustainable once the real exchange rate had returned to its long term equilibrium level.

The MPC discussed recent financial market developments. The Committee was of the opinion that measures to drain liquidity from the market by auctioning 28-day CDs had been successful and noted that interbank market trading had resumed, although volumes were still limited. Treasury bill yields had also moved closer to the Central Bank deposit rate. However, some Committee members expressed concerns that the banks' deposit rates had not risen commensurably.

The Committee saw the CD issuance as a tightening of the monetary policy stance after considerable unintended relaxation in the weeks prior to the last meeting. The effective monetary policy stance was in the 9.0-9.5% range at the time of the November meeting.

The Committee agreed that the progress made in important matters since the last meeting allowed for either an unchanged monetary policy or a slight easing. CD bid rates of a minimum of 9.5% and a maximum of 10.0% to 10.25% were discussed, as was the possibility of increasing the volume of CDs offered. The range discussed for the deposit rate was from 9.0% to 9.5%. The Committee also discussed whether to leave its collateralised lending rate unchanged or to lower it to 11.0%, and whether to cut the overnight lending rate from 14.0% to 13.5%. There were some concerns that lowering the collateralised lending rate could be perceived as a relaxation of the monetary policy stance over and above the slight relaxation implicit in the decisions on the deposit rate and the CDs. Concerns over the lack of transparency of the decision were also expressed. However, the need to adjust the interest rate corridor was acknowledged.

It was argued that, in its decisions, the Committee had to weigh together three factors: the inflation outlook, the output gap, and the interim objective of exchange rate stability. The weight on exchange rate stability was currently paramount, but the weights will evolve through time as the situation changes or new information affects the assessment of past and current conditions. Some Committee members argued that new information on corporate sector balance sheets and the newly passed bill on debt restructuring indicated that the weakness of the króna might be somewhat less of a danger to private sector balance sheets than previously thought, and ongoing debt restructuring should reduce this exposure further. This would therefore give the MPC some additional room for manoeuvre in favour of the real domestic economy.

In light of the discussion, the Governor proposed that the deposit rate (current account rate) be lowered by 0.5 percentage points to 9.0%, and that the maximum volume at weekly auctions of 28-day certificates of deposit (CDs) be increased from 25 b.kr. to 30 b.kr., with a minimum bid rate of 9.5% and a maximum of 10.25%, which implies a 0.25 percentage points increase in the maximum interest rate.

The Governor invited other MPC members to vote on the proposal. Four MPC members voted in favour of the Governor's proposal, and one member voted against, calling for rates to be kept unchanged.

All members agreed to lower the collateral lending rate from 12% to 11% and the overnight lending rate from 14.5% to 13%, as this would not change the effective monetary policy stance.

In the Committee's view, these rate changes will align the Central Bank interest rate corridor more closely with the effective monetary policy stance, which, before this decision, featured interest rates ranging from 9.5% to 10.0%. The current decision would entail an unchanged or slightly easier stance, depending on CD volumes and rates in coming weeks.

The Committee agreed that, if the króna remains stable or appreciates and inflation continues to fall as forecast, a further gradual easing of monetary policy should become possible. The MPC reiterated its intention to move cautiously, however, and stressed that it stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability, while ensuring that inflation will be 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 Thursday 10 December 2009.

Speech by Governor Már Guðmundsson at a breakfast meeting of the Iceland Chamber of Commerce, 6 November 2009

In general, monetary policy is conducted under conditions of uncertainty. The future is always uncertain, of course, but so are the present and the recent past – at least, when one is assessing the state of the economy. This is axiomatic to anyone who has had to wait for national accounts figures in order to estimate current GDP growth and has then seen statistics revised repeatedly over a period of several years. Another source of uncertainty is the effect of monetary policy instruments on other interest rates, exchange rates, asset prices, demand, and inflation. Naturally, we know a great deal about the relationships in the economy, but we don't know what the correct model of it is, and we probably never will, as economic structures change over time. Furthermore, expectations play a key role in the entire process, and while they may remain reasonably stable for a time, other periods of time will come, and expectations will become unhinged. The relationship between interest rates and exchange rates under conditions of free cross-border movement of capital is different to the relationship that exists under capital account restrictions. In general, the monetary policy transmission mechanism depends on the maturity of the financial markets. These uncertainties and complexities, of course, are the reason for monetary policy committees and heavily staffed central banks.

If monetary policy is complex under normal circumstances, the complexity is multiplied in a financial crisis, especially a crisis as deep as the one that Iceland has been going through. Some of the markets that are important for monetary policy transmission stopped functioning to a substantial degree. Financial institutions became impaired, and they responded differently to the Central Bank's monetary policy instruments than they did before the crisis. The relationship with the rest of the world changed. The link between exchange rates and interest rates weakened. And expectations became seriously unstuck. Matters were further complicated because we had to change the rules of the game in response to the crisis; for example, by imposing capital controls.

It is important to remember this when evaluating monetary policy in Iceland under the current circumstances. At present, the monetary policy framework is defined by the economic programme agreed between the Icelandic Government and the International Monetary Fund (IMF). The other key elements of the programme are the medium-term fiscal sustainability plan and the financial market restructuring plan.

According to the programme, the most important task of monetary policy is to promote exchange rate stability. One reason for this is the currency crisis that accompanied the financial crisis, pushing the exchange rate far below levels previously thought possible, let alone desirable. This currency collapse fuelled inflation, of course, and amplified the debt crisis faced by households and businesses. Two factors played leading roles in that development. The first is the relatively large share of foreign-denominated loans – an average of 20% for households and 70% for businesses. The latter factor is an unusually strong exchange rate pass-through effect, which stems from the magnitude of the exchange rate drop and the lack of confidence that the króna would recover in the near future. As a result, the principal of indexed loans – which constitute about 70% of household debt and 10% of business debt – was written up. As is often the case in severe financial crises that are at the same time country crises, there was a genuine risk of a multi-faceted spiral of currency collapse, inflation, debt crisis, and economic contraction. It was critical to stave off such a vicious cycle, and therefore of vital importance to stabilise the exchange rate.

But this was problematic because of the large amount of capital that had accumulated in Iceland through carry trading during the economic upswing. Current estimates indicate that some 500 b.kr. remain in the Icelandic economy. There was the risk that this money would try to escape through a collapsed foreign exchange market, with unimaginable consequences for the exchange rate. Thus it was quite possible that astronomical interest rates would have been required if exchange rate stability were to be achieved through interest rate policy alone. In view of this, it was decided to impose broad-based capital account restrictions and thereby create the scope for less restrictive monetary policy than would otherwise have been feasible.

As is usually the case, there were probably other options available at the time. But because I prefer to focus on the current situation and the road ahead, I would prefer not to spend time rehashing the past and ruminating about hypothetical options. Such speculation cannot change the past. Generally speaking, however, it seems to me that other options would have entailed significantly higher interest rates – initially, at least – and more risk to the exchange rate. But that doesn't change the fact that, although the capital controls provided a certain temporary shelter, they also entail significant cost and inconvenience, which probably vary directly with the length of time the controls are in place. That cost will ultimately cut into GDP growth for the short term and reduce the level of GDP in the longer term. Understandably, then, we do not wish to maintain the capital controls a minute longer than necessary.

Strictly speaking, monetary policy is not based on an inflation target at present – at least, not for the short term – as the interim goal of arresting the fall of the króna and then stabilising it has taken priority. Ultimately, of course, this policy is consistent with the attainment of the inflation target. It would have been tempting to take somewhat greater short-term risk with the exchange rate and direct monetary policy more toward domestic economic conditions and the inflation outlook, but the enormous damage that even a short-lived additional depreciation would have done to private sector balance sheets precluded such an approach.

Under conventional circumstances, inflation-targeting monetary policy can be described, albeit in an oversimplified way, as entailing a policy interest rate that takes into account three factors: 1) the desired policy rate when inflation is at target and GDP is at potential; 2) the output gap; and 3) the deviation of inflation from target. In the case of Iceland, the exchange rate must be added to this list, and with a heavy weight. But the weight of the other items is not zero, and the importance of the exchange rate should diminish as the financial crisis relinquishes its grip and we reduce the weight of foreign debt in private sector balance sheets, thereby reducing the impact of the exchange rate on domestic liabilities. One of the Monetary Policy Committee's many tasks at present is to assess how these various weights should evolve as circumstances change.

Indicators presented at the most recent Monetary Policy Committee meeting suggest that foreign-denominated debt may weigh less heavily in corporate sector debt than was previously believed, and that it is currently diminishing in importance for both households and businesses. Before the banks collapsed, an average of 70% of corporate sector debt was denominated in foreign currency. But the distribution is quite skewed. Holding companies had a large share, and large and medium-sized firms were more likely to have foreign debt than were small firms. Over half of businesses had domestic-currency debt only. In addition to this, the weight of households' and businesses' foreign-denominated debt will probably decline in the near future, both due to debt restructuring and because the vast majority of new bank loans are in domestic currency. The banks have limited capacity to lend in foreign currency, both because of a shortage of foreign exchange and because they are operating under temporary exemptions from Central Bank rules on maximum foreign exchange imbalances. Of course, this is good news, in a sense, because the sooner the weight of foreign debt diminishes, the sooner monetary policy will be released from the straitjacket of restraint far greater than is desirable in light of current domestic economic conditions. Other factors that could help in this context are new foreign exchange inflows and lower risk premia on domestic króna-denominated assets, which would obviate the need to maintain exorbitant interest rates in order to keep ISK assets in the country or attract new capital.

I have expanded at some length on current monetary policy objectives because I consider it important that these objectives be understood. But what are the instruments of monetary policy? It can be said that, apart from reserve requirements and other similar tools, which are seldom changed, the Bank's interest rate decisions, foreign exchange market intervention, and capital controls are its chief monetary policy instruments. These instruments must be properly aligned, and consequently, interest rate decisions take account of capital controls. The controls provided some shelter for interest rate decisions for a while; however, as soon as they are relaxed, interest rates must be high enough to give investors an incentive to hold ISK assets. Just how high they must be is determined in part by the risk premium on the Republic of Iceland, which fortunately has declined significantly in the recent term. For example, the Republic's CDS spread has fallen from around 1000 basis points at the beginning of the year to about 350 points.

But what about foreign exchange market intervention? It is a tricky instrument and, if misapplied, yields nothing at best and generates enormous losses at worst. Refusing to use it at all, however, would be unnecessarily extreme. One of the lessons of the financial crisis is that the proper deployment of foreign exchange reserves can be of key importance in preserving monetary and financial stability under difficult circumstances. This is supported by innumerable examples from countries from Brazil to Korea. There is no benefit in amassing foreign exchange reserves during an economic upswing if one is chary of using them in times of need. The public sector can take a broader view than the private sector because it is able to take a longer-term position with or against its own currency, thereby smoothing out cycles, and profit on the whole arrangement. Australia and other countries have at times used this strategy successfully, in spite of an inflation target. But there is no sense in protecting an unrealistic exchange rate through thick and thin, nor does it make sense to draw a line in the sand vis-à-vis the market. Under those circumstances, it is better to adopt the military strategy of Genghis Khan, who often began by retreating, luring his opponents from their fortresses and then annihilating them out on the steppes.

At present, foreign exchange market intervention in Iceland aims at mitigating exchange rate volatility and preventing a spiral of currency depreciation and expectations of further depreciation. Since the banks collapsed, the Central Bank's foreign exchange market intervention has all been in one direction: It has sold foreign currency. In the past few months, however, intervention has been reduced significantly in comparison with, for example, January and February, and then May and June. Nonetheless, 2009 figures year-to-date are quite high, at over 80 million euros.

Is too much risk being taken? As long as intervention remains modest, I think not. There is no doubt that the equilibrium exchange rate of the króna has fallen sharply after the past years' accumulation of debt and the ensuing collapse of the banking system. I think there is little doubt that the current exchange rate is below this new, lower equilibrium rate, as is often the case in a financial crisis. However, there is great uncertainty about how far below equilibrium it is. There is also considerable uncertainty about how much the equilibrium exchange rate will rise in coming years and how much the exchange rate will correct itself. The Central Bank's newly published forecast assumes that the exchange rate of the króna against the euro will remain close to current levels until well into 2010, whereupon it will gradually rise to about 170 in 2011 and 2012. We hope, of course, that this forecast is unduly pessimistic, and experience tells us that the currency can appreciate swiftly once it gains upward momentum. But it would be imprudent to base plans and policy actions on such a hope. On the contrary: I believe we should prepare ourselves for a protracted episode of weakness. And, like so many other things, there are both pros and cons associated with such a development.

That doesn't change the fact that we would all have to make a concerted effort to botch things in order to prevent the exchange rate from being considerably higher in a few years' time than it is today. But then we will have to remember to buy back the foreign exchange that we have used to support the króna in 2008 and 2009. If we do that, then we might profit on the whole arrangement.

I expect this spurs questions about whether we need all of the loans that we have negotiated as a part of the IMF programme. In my opinion, this is an eminently justifiable question. First of all, we need the loans in order to ensure that we have sufficient foreign exchange at all times to enable us to pay amortisation and interest on the foreign debt of the Treasury and Treasury-guaranteed entities. As far as the Treasury is concerned, there will be little activity until late in 2011, when a loan of one billion euros, taken in 2006 to reinforce the foreign exchange reserves, will mature. But we can also use the loans to buy the bonds from this series and others offered in the secondary market at low prices, thereby easing the debt service burden and profiting on the whole arrangement. Furthermore, we will need reserves in order to engage in moderate foreign exchange market intervention, with the aim of supporting the króna and reducing volatility. And last – but certainly not least – we need reserves in order to create confidence in the króna and fend off those who would attack it. But such an arsenal, which is only to be used in an emergency, is extremely expensive because it is impossible to invest the reserves at rates comparable to those on the loans themselves without taking an unacceptable amount of risk. Thus it is important to avoid borrowing more than necessary and to emerge as soon as possible from our current state of imbalance.

Before I turn to the economic outlook and the Monetary Policy Committee's most recent interest rate decision, I consider it necessary to say a few words about the nature of the adjustment the Icelandic economy is currently undergoing. First of all, it should be borne in mind that the year 2009 would have been extremely difficult in any case, no matter whether the banks had collapsed or not. This is because of the huge macroeconomic imbalances that developed in the Icelandic economy in 2005-2007 and had to subside in one way or another. Second, the collapse of the banking system called unavoidably for an additional adjustment in the structure of the economy. We can summarise this as follows: The enormous current account deficit had to go, and the financial system and various other bubble-related operations had become far too large and had to be downsized. This involves considerable unemployment, partly because of layoffs in the sectors that have contracted and the lag time before new commercial activities can be established. Tradable sectors must be reinforced. The key to hastening that process is re-establishing an effective financial system. Although the currency may have played a role in creating the problem, the depreciation is also part of the adjustment, and it is accompanied by transitory inflation. However, when the adjustment is over, we should not be faced with persistent inflation, and it is the chief role of monetary policy to try to ensure that inflation does not become entrenched.

The Central Bank published a new macroeconomic forecast yesterday, as well as announcing the Monetary Policy Committee's interest rate decision. The highlights are as follows:

- GDP will contract by about 8½% in 2009 and by almost 2½% in 2010.
- The contraction for 2009 is rather smaller than previously forecast.
- Private consumption has declined less sharply so far in 2009, probably because disposable income rose more in 2008 than previously forecast, and because of pension fund payouts amounting to some 1½%of GDP in 2009.
- In addition, unemployment has risen less than previously projected.
- Recovery will begin in early 2010, in the sense that quarter-on-quarter GDP will begin to grow.
- At that point, however, Icelanders will still consider the situation unfavourable, and it will keep deteriorating for a while, as unemployment and the output slack will continue growing well into the year, as will the contraction in private consumption.
- As the second half of the year progresses, these factors, too, will begin to improve.
- As always, these projections are uncertain, and the economic recovery could prove stronger or weaker. For example, one of the alternative scenarios in the new Monetary Bulletin assumes a considerable delay in the construction of the Helguvík aluminium smelter and related power facilities, with the bulk of the development taking place in 2012. Economic recovery is delayed, and the contraction in GDP will be 4% in 2010, instead of just under 2½%.
- Inflation has been higher than forecast in the recent term, as a result of a weaker króna and a slightly smaller output slack than previously projected.

- Inflation will subside quickly in 2010, however, and underlying inflation will be at or near target in the latter half of the year.

As regards the current economic situation, the outlook I have described here, and indicators that private sector balance sheets are somewhat less exposed to exchange rate risk than previously thought, the Monetary Policy Committee decided to make changes in Central Bank interest rates that entail an unchanged or slightly more relaxed monetary policy stance. The main change, however, involves adapting the Central Bank interest corridor to the effective level of monetary restraint, which is currently determined primarily by interest on the Bank's current accounts and certificates of deposit. If the króna remains stable or appreciates, and if inflation falls as forecast, then the preconditions for further monetary easing should soon be in place.

Available forecasts assume that the Icelandic economy will recover in the next few years. We also hope we will be quick to escape the fetters of the capital controls and the predicament faced by monetary policy as a result of the debt crisis and the large proportion of foreign-denominated debt. It will then be time to determine a new monetary policy framework. Joining the European Monetary Union could be an option in due time, but it is not a certainty, and in any event, it will take some time to materialise. The most obvious choice is therefore to adopt some sort of inflation target and floating exchange rate. That is a topic for another speech, but for the moment, suffice it to say that the experience of the past several years, both in Iceland and elsewhere, indicates that such an inflation-targeting regime would have to be somewhat different than the pre-crisis regime. It must be much better supported by fiscal policy, macroprudential financial market regulation, and effective financial supervision. It would have to be an "inflation target-plus" framework, which would specifically include accumulating foreign exchange reserves during upswings in the exchange rate cycle and using them in times of need.

Thank you.

August 5, 2009

Capital Control Liberalisation

A. Introduction

While controls were deemed necessary to stabilise the Icelandic economy following the financial crisis of October 2008, gradual removal of the controls is an important step towards normalising economic conditions. Icelandic businesses view access to capital markets, international funding, and investments as one of the main preconditions for economic recovery.

Even though gradual removal of the controls is a priority, the sequencing must be carefully designed in light of the remaining imbalances of the Icelandic economy. The sequence of the policy mix is thus designed in a way that allows each step to be taken while preserving the stability of the króna.

During the liberalization phase, underlying economic developments and policies will be in place that should contribute to the stability of the króna: 1) Each liberalization step will only be taken when the certain preconditions are in place, 2) Monetary policy will be conducted in a way that promotes stability, 3) Expected progress on the recovery program and a prospective current account surpluses will support the krona, 4) The Central Bank will have in place very sizeable currency reserves.

This document is divided into the following sections:

- Reasons for introducing controls
- Current capital controls regime
- Preconditions for liberalisation
- Liberalisation strategy
- Administration and enforcement

B. Reasons for introducing controls

The period 2005-2008 saw significant capital inflow into Iceland. The combination of wide interest rate differentials and an appreciating currency attracted international capital, some through 'normal' financial investments and some through instruments (e.g., glacier bonds) constructed to benefit from this combination. Some inflow was also linked to the Icelandic financial system and international borrowing by Icelandic companies. As a result, non-residents held large positions in Icelandic krónur (ISK), some immediately available and some available through 2009-2010 as the instruments matured. Non-residents' ISK positions totalled 680 b.kr. in late 2008. Short-term positions totalled approximately 330 b.kr.

In October 2008, Iceland suffered a banking crisis of extraordinary proportions. The ensuing loss of confidence threatened to trigger large capital outflows, with highly adverse effects on an already weakened exchange rate. Such capital outflows (immediate and delayed) could have led to further depreciation of the króna, and higher inflation. Because private sector balance sheets are characterised by both high leverage and a large proportion of foreign-denominated and inflation-indexed debt, this could trigger a wave of defaults, with adverse macroeconomic implications. Consequently, on October 10, the Central Bank introduced measures to temporary modify currency outflow.

Given the substantial macroeconomic risks, capital controls were an unfortunate but indispensable ingredient in the policy mix that was adopted to stabilise the króna when the interbank foreign-exchange market was restarted in early December 2008.

C. Current capital controls regime

The current capital controls were adopted on November 28, 2008, according to the Rules on Foreign Exchange (the Rules), which were authorised by a provision in the Act on Foreign Exchange. The Rules were reissued on December 15, 2008, and in mid-March the Foreign Exchange Act was amended so as to tighten the controls. In parallel, clarifications of the Rules have been issued on numerous occasions.

Payments linked to current account transactions and inward FDI were released after a short period of time. Thus, transactions involving actual imports and exports of goods and services are allowed and so are interest payments, if exchanged within a specified time limit. Most capital transactions are controlled both for residents and non-residents;

that is, their ability to shift between ISK and FX is restricted. Króna-denominated bonds and other like instruments cannot be converted to foreign currency upon maturity. The proceeds must be reinvested in other ISK instruments. Furthermore, the Rules require residents to repatriate all foreign currency that they acquire.

Certain companies, including major exporters and firms with large international operations, were given full or partial exemption from the Rules upon fulfilment of certain criteria.

The Foreign Exchange Act is under the auspices of the Ministry of Business Affairs; however, the Act authorises the CBI to issue the Rules on Foreign Exchange, which are subject to the Minister of Business Affairs' approval. The CBI is responsible for the overall surveillance of the capital controls and for the day-to-day administration of the Rules. That surveillance has gradually been stepped up. According to the Foreign Exchange Act, the Financial Supervisory Authority (FME) shall investigate possible violations of the capital controls when notified of such suspected violations by the CBI. To ensure effective and efficient cooperation between the CBI and the FME, the two institutions signed a collaboration agreement in June 2009.

Circumvention of the capital controls is to be identified by the CBI. Data on transactions and flows are monitored, and possible circumvention is identified. The general impression is that the majority of Iceland's largest companies and financial institutions are operating according to the letter and intention of the law. However, many are building up their own FX reserves (primarily in Icelandic banks) as a buffer/hedge that limits their conversion to krónur.

With effective controls in place, exchange rate developments will be determined largely by current account flows (i.e., exports, imports, interest payments, and debt repayment), but not, as has been for the last 5 to 8 years, predominantly by capital flows. However, the market is shallow.

Because the current account has been broadly balanced, capital controls have helped to stabilise the exchange rate by preventing large capital outflows and thereby enabling the CBI to lower its policy rate. The controls have also provided a relatively stable environment for bank restructuring and have kept liquidity in the system.

In general, it appears as if the tension in the system has been reduced over the past few months. The spread between the ISK exchange rate in the onshore and offshore markets has narrowed. According to CBI statistics, ISK holdings of non-residents have declined from approximately 680 b.kr. at year-end 2008 to roughly 610 b.kr. at end-July 2009. Long-term holdings have increased slightly, while short-term positions have fallen from about 330 b.kr. to 260 b.kr. Although these figures are somewhat uncertain, they suggest a significant reduction in the possible overhang of non-resident ISK positions.

Non-residents appear to be relatively comfortable holding ISK assets in the form of Government bonds/HFF bonds, and CBI and bank deposits. There has been limited interest in shifting from such ISK positions to longer-term euro positions through the 'impatient investor' measures introduced in May 2009.

Overall the estimate is that at least half the ISK positions are attractive for non-residents in the longer term; e.g., long-term HFF bonds. In May 2009, the CBI estimated that around 250-300 b.kr. were held by "impatient" non-resident investors who would either need to be given incentive to stay, substituted by other non-resident or resident investors establishing ISK positions, or locked in during the initial phases of liberalization .

After the recent turbulence, it should be expected that some residents may want to shift out of the króna in order to balance their risks (earnings, currency, and solvency) and perhaps access instruments that cannot be fully acquired in krónur (equity, equity portfolios, and some fund categories). However, Icelandic instruments may be seen to provide an attractive mix of direct earnings and/or currency upside.

D. Preconditions for liberalisation

A significant reduction in the perceived risk of investments in Icelandic assets is a precondition for removing the capital controls. The Icelandic króna has depreciated some 5% against the euro since January 1, 2009; however, model projections (see the CBI's *Monetary Bulletin* 2009/2) suggest that the króna may appreciate substantially more than 5% by 2011, while still allowing for necessary improvements in the current account. With such developments, and with ISK interest rates currently well above international rates, the fundamental incentives for investors to hold their ISK positions should be in place. However, even though Iceland's risk premium has declined in line with and beyond international trends, it remains relatively high.

Over the past few months, many important steps have been taken to alleviate this situation. With the adoption of a medium-term fiscal plan, the Government has taken an important first step towards fiscal consolidation. Substantial progress has been made on the bank recapitalisation process, which is facilitated by new legislation on an asset management company and a bill of law on State banking agency. The IceSave loans and loan agreements with the Nordic countries have been signed. Together with the IMF loan facility, the Nordic loans bring total reserves to about 5 bn US dollars. The monetary policy has been focused on currency stability as and interim objective, and inflation has lost pace. A Stability Pact has been concluded between the Government and the social partners. Furthermore, exports have proven strong and imports weaker than expected, translating a sharp drop in domestic demand into a relatively moderate drop in GDP combined with a positive trade balance.

Against this background, the stage should be set for the achievement of the following preconditions over the next several months.

i. Full implementation of the macroeconomic stabilisation package. This includes the following:
    a. Confidence in the sustainability of government debt must be enhanced by a strong commitment to a medium term plan of fiscal consolidation. This would demonstrate that, although burdensome adjustments will be required, the Republic will be fully able to service its debt.
    b. Communication of the sustainability of the external debt situation, the mechanisms by which sufficient FX earnings to strengthen the króna will be ensured and a capital control liberalisation strategy designed to preserve the stability of the króna.
    c. Continued disinflation and a monetary policy focused on exchanged rate stability, as is illustrated in the last statement from the Monetary Policy Committee (MPC).
    d. The availability of instruments with attractive characteristics (deposits, bonds, FDI) to induce residents and non-residents to hold or establish longer-term ISK positions.

ii. Establishment of a strong, well-managed, and adequately supervised financial sector.

iii. Implementation and operation of an efficient liquidity management framework.

iv. Accumulation of adequate reserves (to support exchange rate stability and banking system liquidity, if necessary).

Stage 1 of the capital control liberalisation strategy – liberalising inflows – should only take place when the above preconditions have been met. It is expected that these preconditions will be in place well before November 1, 2009.

After Stage 1 is completed, later stages of the liberalisation process (liberalising outflows) will be initiated gradually, at the CBI's discretion, concurrent with the accumulation of surplus reserves to help cushion potential exchange rate volatility. Restored confidence in the Icelandic banking sector and equity market will be a particularly important prerequisite for liberalising capital outflows.

E. Liberalisation strategy

The liberalisation process will be closely managed to support the CBI's reserve management policy and the main monetary policy objectives of exchange rate and price stability. It takes place according to a sequence that is defined yet flexible, so as to allow for adjustments.

During Stage 1, controls on all foreign exchange capital inflows will be removed in a relatively short time frame. During Stage 2, the strategy distinguishes accounts, asset classes, and transactions to be liberalised early in the process from others that are to remain controlled for a longer period of time. The latter group – the so-called blocked accounts – will include those with significant potential for outflows and those whose early liberalisation could undermine the effectiveness of the system. Stage 2 will begin with the gradual liberalisation of outflows from specified accounts with the longest maturities, asset classes, and transactions, commensurate with the external reserves, the balance of payments outlook and increased confidence in the domestic banking sector. Once the release of these accounts is complete and sufficient surplus reserves have been accumulated, the next group of accounts and asset classes will be gradually released. The use of Icelandic krónur for international transactions will remain controlled until the final stage of liberalisation.

Stage 1: Liberalisation of foreign exchange inflows

At the beginning of Stage 1, new investments involving new FX inflows will be liberalised. New FX inflows exclude current FX deposits with domestic banks and FX current account transfers (e.g., export revenues). The new FX inflow shall be converted into krónur at a financial institution supervised by the FME. Such ISK holdings will be fully convertible and transferable. The new investment must be registered with the CBI in order to be eligible for re-exit. This will enable the CBI to monitor the inflow and possibly intervene by acquiring FX to build surplus reserves. No distinction will be made between investors making such an FX-to-ISK conversion. To minimise possible circumventions, certain investments, such as leveraged derivative instruments, will not qualify for re-exit.

Stage 1 is expected to have a positive or limited effect on the reserves. Initial inflows should strengthen the króna, providing the CBI with an opportunity to intervene to limit volatility and build up reserves for possible outflows stemming from the new investment.

Stage 2: Liberalisation of foreign exchange outflows

Stage 2 is based on a distinction made between accounts, assets, and transactions that can be released without the risk of large capital outflows, on the one hand, and blocked accounts that must remain controlled for a longer period of time, on the other. As an example liberalisation of long-term holdings is not considered likely to generate a substantial outflow of capital. These holdings will therefore be liberalised, gradually, before short-term holdings. Such accounts are and will remain blocked.

The CBI stands ready to tighten administration of "blocked accounts" if the situation requires.

Batch A:

In Batch A, holdings that meet specific long term maturity criteria, to be determined by the CBI, can be sold and the investor can convert the proceeds from krónur to foreign currency. In general the liberalization process will gradually allow the convertibility of the longest term investments. All such conversion must be made with a financial institution supervised by the FME. To avoid churning by investors, the investor must provide documentation to verify a given holding period up to a specific cut-off date to be determined by the CBI. This will enable the CBI to monitor the outflow. The CBI will implement procedures for this process.

These holdings will gradually be made convertible and transferable according to a threshold schedule consistent with the availability of surplus reserves. The transferability of residents' proceeds may initially be limited, according to current repatriation requirements, which stipulate that the proceeds must be deposited in specific accounts with domestic financial institutions. The use of these holdings will gradually be allowed for specified outward investments, sequenced from long-term to short-term AAA bonds and securities.

Stage 2 will be carefully managed and sequenced in line with the CB's reserve policy and the broader objective of exchange rate and price stability. The timing, conditions and thresholds for liberalization will be chosen in line with these objectives. Reserves will be available for intervention in the FX market to reduce excess volatility If a large number of investors choose to convert their assets, it will tend to lower the market value; that is, to a level that is not attractive for conversion. This will limit the total amount converted into FX.

Batch B:

Liberalization of asset categories as defined in Stage 2, Batch A can continue, gradually liberating the medium to short-term instruments. In addition, as sufficient reserves are accumulated, the Government will issue and auction short-term euro-denominated bills under its EMTN programme. In the auctions, successful bidders will be offered to convert krónur to euros at the CBI's official rate in order to purchase the bills. In essence, investors will be converting their ISK holdings into a transferable euro-denominated asset.

The price, amount, and timing of the procedure will be controlled by the CBI. It will provide all investors intending to exit with equal treatment, and the exit will be regulated by a price-based control. The decision to exit or not will be left to the investor; however, the total amount of foreign exchange used for this purpose will be subject to a predetermined limit. Since the auction mechanism will allow those who are willing to pay the highest amount to exit, it will permit the most impatient investors to leave first and immediately lessen the incentive to circumvent. This will allow for a flexible management of both reserve positions and exits, depending on balance of payments flows, yet without requiring long-term reliable balance of payments projections.

As the total amount of foreign exchange used is kept within a predetermined limit, reserves will remain within comfortable levels. The process will not have a direct effect on the interbank market. The cost effects of reserves used will be minimised, as the price is determined by the market.

All the above mechanisms are consistent with the international obligations of Iceland.

F. Administration and enforcement

Surveillance by the CBI

The administration of the strategy will be carefully designed to ensure compliance. The CBI is responsible for the surveillance of the capital controls, and it will devote to the task the resources and remedies necessary to carry it out successfully. The surveillance operation will cover the following three areas:

a) General surveillance

The CBI will have in place a general surveillance operation carried out on a daily, weekly and/or monthly basis, depending on the subject. The scope of such general surveillance will be extensive enough to enable the Capital Control Surveillance Unit (CCSU) to monitor and spot out possible violations of the Rules on Foreign Exchange. Such monitoring requires access to a range of data that will be obtained both within the CBI's systems and from other sources. Such data access must be continuous; i.e., it must not be dependent on the CBI's requesting it on a case-by-case basis. As a result, the CBI will need to establish collaboration with various sources from the public sector. As regards the private sector, the CBI will make general requests for the provision of specific data on a regular basis; e.g., in reports. The scope of the general surveillance operation will be as exhaustive as possible, and every data process will be described in as much detail as possible. This will allow the CCSU to determine certain references or benchmarks in its monitoring, which will give the general surveillance operation a sufficient overview. Such definitions, descriptions, and determinations will be reviewed regularly to ensure the best results possible.

b) Specific surveillance

In certain business sectors, companies and individuals have greater incentive and opportunities to circumvent the Rules on Foreign Exchange. The CCSU's surveillance will therefore target such high-risk sectors on regular basis. The specific surveillance operation will also target companies and individuals that have been granted exemptions from the Rules.

c) Case-by-case inspection

If the CCSU becomes aware of a possible violation of the Rules, either through its surveillance operations or through information provided by a third party, the CCSU will investigate such possible violations and may request additional data. Such inspections would be made on a case-by-case basis and, if applicable, would form the basis for the CBI's reporting of suspected violations to the FME.

CBI's resources and remedies

In order to fulfil its surveillance obligations, the CCSU will need additional staff. The CBI has already committed to recruit new members to the unit in response to the immediate need.

As regards data collection, the CBI will request clearer regulatory authority to request data pertaining to foreign exchange matters, and remedies at its disposal if such requests are ignored. In order to ensure adequate data collection, it is necessary to amend the Foreign Exchange Act and to adopt additional rules. Furthermore, the CBI will have to be able to oblige the financial sector to implement internal rules on observance of foreign exchange matters and to report any possible violation of the Rules on Foreign Exchange to the CBI. Therefore the CBI will request amendments to the Foreign Exchange Act to include such an obligation.

In addition to the surveillance operations described above, the CBI in collaboration with the FME enhance monitoring the commercial banks' compliance with the regular supervisory work of the FME. These steps are currently being prepared by the CBI and the FME.

Steps to increase voluntary compliance

The CBI will take measures to make the interpretation and implementation of the Rules on Foreign Exchange more transparent and accessible to interested market participants. The CBI's responses to questions and interpretations will be published regularly on its website. This should increase transparency and minimise the risk of unequal treatment.

In general, the CBI has begun to interact more frequently with the financial sector regarding the capital controls. The knowledge and actual overview that can be obtained through the financial institutions is vital to the efficient surveillance of the controls. Enhanced collaboration with the financial sector, including the Icelandic Financial Services Association, has commenced.

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First stage of capital account liberalisation

The Central Bank of Iceland has taken the first step in the sequenced removal of the capital controls by permitting inflows of foreign currency for new investments and potential outflows of foreign currency that may derive from such investments in the future. This means that investors are authorised, without restrictions, to convert into foreign currency the sales proceeds from assets in which they invest after November 1, 2009. Previously, non-residents were fully authorised to transfer foreign currency deriving from interest and dividends on investments in Iceland.

Foreign exchange inflows for new investments will be converted into Icelandic krónur by financial undertakings operating under the supervision of the Financial Supervisory Authority. If the subsequent transfer of that capital out of Iceland is to be authorised, the new investment must be registered with the Central Bank of Iceland. This will enable the Bank to track inflows and strengthen the foreign exchange reserves through market intervention if circumstances permit.

In addition to the above-specified amendments, the Rules on Foreign Exchange have been revised with the aim of enhancing consistency and closing loopholes that have been used to circumvent the capital controls. The most salient amendments are the following:

- Exemptions granted to various parties – including municipalities and publicly owned undertakings, undertakings with investment contracts, and other parties – have been revised; cf. Article 14 of the Rules on Foreign Exchange.
- Movements in krónur have been specially restricted in order to facilitate enforcement and prevent abuse of the Rules; cf. Article 2, Paragraph 3.
- The authorisation to reinvest has been expanded and the exercise of that authorisation facilitated; i.e., as regards reinvestment of dividends and capital gains; cf. Article 5, Paragraph 1.
- Increased restrictions are placed on investments in other assets in order to limit opportunities to circumvent the Rules; cf. Article 6.

As opportunities for foreign exchange transactions related to movement of capital are expanded, new possibilities for circumventing the remaining capital controls may emerge. As a result, it is necessary to strengthen surveillance of the controls. The Central Bank has already done this by restructuring and reinforcing its Capital Controls Surveillance Unit, as was announced in the Bank’s press release no. 30/2009. In order to reduce the risk of circumvention, the authorisation to re-transfer capital out of Iceland does not extend to certain types of investments; for example, leveraged derivatives contracts.

The Central Bank will publish guidelines for the Rules and will update them as necessary.

The capital controls imposed on November 28, 2008, were considered necessary in order to stabilise the economy in the wake of the financial crisis that struck Iceland in October 2008. The conditions necessary for the initial stage in removing the controls, in accordance with the capital account liberalisation strategy presented by the Bank on August 5, 2009, have now developed. A long-term fiscal consolidation programme has been prepared, as has the National Budget bill for 2010, which entails considerable restraint. Conditions for exchange rate stability have improved. The First Review of the macroeconomic programme of the Icelandic Government and the International Monetary Fund has taken place, ensuring that the Central Bank has access to increased foreign exchange reserves.

The next phase of capital account liberalisation – the removal of restrictions on capital outflows – will be determined by the success of this phase and the progress made under the macroeconomic programme.

Further information can be obtained from Ingibjörg Guðbjartsdóttir head of the Capital Control Surveillance Unit of the Central Bank of Iceland, at tel (+354) 569-9600.