

## 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.