Monetary policy statement by the Board of Governors of the Central Bank of Iceland

Of vital importance to stabilise the foreign exchange market and strengthen the króna

The króna depreciated sharply both before and after the financial crisis struck in October. The real exchange rate of the króna, currently at a historical low, is much lower than is sustainable for the long term. In November, the real exchange rate was approximately one-third below the average from 1980 to the present. At the end of November it was probably about 20% below its lowest point during that period. This drop in the exchange rate triggers higher inflation and jeopardises the financial position of many households and firms. Thus it is of paramount importance to restore exchange rate stability. The Central Bank will work towards that end.

The Government of Iceland and the Central Bank have formulated a monetary and economic policy that aims at creating lasting stability in exchange rate and economic matters. They consulted with the International Monetary Fund in preparing this policy, which focuses on three main objectives. First, it provides for tight monetary policy that fosters stability in the foreign exchange market and the strengthening of the króna. Second, it emphasises the necessity of exercising fiscal restraint. A temporary deficit is unavoidable in the wake of the shock that the economy has sustained. Long-term fiscal policy must aim at maintaining a manageable level of public sector debt and debt service in spite of lost revenues and increased expenditures. Finally, the policy recognises the need to restructure the financial system in accordance with transparent, internationally recognised principles.

In order to pave the way for stable foreign exchange market activity and in accordance with the agreement with the International Monetary Fund, the Board of Governors of the Central Bank raised the Bank's policy interest rate to 18% on October 28.

The temporary foreign exchange restrictions that were necessary in order to guarantee a basic level of functioning in Iceland will be lifted in stages. The Central Bank's guidelines for financial institutions concerning limitations on the sale of foreign currency have been revoked. Restrictions remain on foreign exchange transactions for movement of capital, and the mandatory submittal of foreign currency to financial institutions has been adopted. This is explained further in a separate press release issued by the Bank today.[1] The restrictions on foreign exchange transactions for the movement of capital will be lifted as soon as conditions allow.

1. *Monetary Bulletin* was published on November 6, 2008. The publication of the Policy Statement of the Board of Governors was delayed until after the Executive Board of the International Monetary Fund had approved the Stand-By Arrangement for Iceland and the subsequent measures had been introduced. The Policy Statement was published on November 28, 2008.

A considerable proportion of króna-denominated securities are owned by foreign investors. Lifting restrictions by stages will make it possible to unwind their króna-denominated positions in a systematic way, as the external balance permits, without undue impact on the exchange rate. This is in the best interests of the Icelandic nation as well as the foreign investors concerned.

Through an auction of Treasury securities in early December and new primary dealer agreements, new life will be breathed into the domestic bond market.

The Central Bank's foreign exchange reserves will strengthen substantially as a result of the loan from the International Monetary Fund. In addition, the currency swap agreements between the Central Bank of Iceland and its counterparts in Denmark, Norway, and Sweden have been extended until year-end 2009. Added to this will be loans from the Faeroe Islands, Poland, Russia, and the Nordic countries. Strong foreign reserves together with other factors will create conditions for a rising exchange rate.

It is not possible to rule out a drop in the exchange rate right after restrictions on foreign exchange transactions for trade in goods and services are lifted. Nevertheless, such a depreciation will likely be short-lived. Underlying economic developments will support the exchange rate of the króna. When domestic demand contracts, imports decline and a surplus develops in the trade account. The trade account is already in surplus and the current account deficit will disappear rapidly.

In light of the above, it is not assumed in advance that the Central Bank will need to intervene in exchange rate developments, either by raising the policy rate or by selling foreign exchange. However, this cannot be ruled out. The Bank will maintain tight control over the banks' access to Central Bank credit until foreign exchange market stability has been achieved.

A stronger currency and a widening output slack will lead to disinflation and a subsequent easing of the policy rate. According to forecasts by the Central Bank and the International Monetary Fund, inflation will taper off quickly in 2009, with the twelve-month rise in prices dropping to below 5% by the end of the year.