

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

Policy rate remains unchanged

The Board of Governors of the Central Bank of Iceland has decided to leave the Bank's policy interest rate unchanged at 18%.

Since the beginning of November, when the Board of Governors last announced its policy interest rate decision and the Central Bank published its macroeconomic and inflation forecasts, various economic factors have become clearer, although substantial uncertainty naturally persists. The króna strengthened markedly after interbank trading resumed in December. It retreated somewhat thereafter, but in the last two weeks it has appreciated again by some 10%. The real exchange rate is still very low, however, and far below historical averages. Furthermore, there is a growing surplus in the trade account. Thus the premises exist for considerable appreciation of the króna. Offsetting this, however, is the fact that terms of trade have deteriorated – sharply in some sectors – as output growth has slowed among Iceland's trading partners. The main task of monetary policy at this time is to contribute to exchange rate stability and foster the appreciation of the króna. The Central Bank's moderate intervention in the foreign exchange market has had a positive effect. Its net foreign exchange transactions only amount to about 3 million euros this year.

Inflation was lower than forecast in the fourth quarter of 2008, or 16.8% instead of the projected 19%, in spite of the fact that foreign currencies were approximately 9% stronger against the króna than the November forecast projected. Most likely, this is largely attributable to external conditions and to the dampening impact of the financial crisis on demand. Today's policy rate decision does not reflect a need to contain domestic demand, as private consumption has fallen off abruptly, for obvious reasons. The wealth effect – caused by constantly rising real estate and equity prices and itself a cause of a surge in consumption – has vanished. Real estate prices have already fallen and are clearly set to fall much further. Unemployment has risen much faster than was forecast in November. Due to these factors and to high inflation, real disposable income has contracted sharply and will continue to shrink. There is good reason to hope that the labour market will respond to these developments in a responsible manner. The damage caused by the fall of the banks has been severe, and it has made a palpable impact on domestic demand, as was forecast. Access to credit from abroad is extremely limited.

Inflation appears to have peaked, and it will decline quickly in the period ahead. For the year 2009 as a whole, inflation is expected to be more modest than was projected in November. In a year's time, it may have retreated to approximately 2½%.

In spite of the substantial trade surplus that has developed in the past few months, the obligation to submit foreign currency, and the restrictions on cross-border capital movements, the króna has appreci-

ated more slowly than the Central Bank expected and considers justified. There may be a variety of reasons for this. Among other things, importers' payment deadlines have become shorter while exporters' have lengthened. Terms of trade have deteriorated, and Iceland's trading partners are faced with mounting difficulties because of the financial crisis currently sweeping the globe. Accumulation of exporters' inventories may also play a part in this trend. Although the exchange rate of the króna has risen more slowly than previously assumed, there is every reason to expect further appreciation in the months to come. This is extremely important.

For the reasons cited above, the Board of Governors of the Central Bank deemed it timely to begin easing the policy rate downwards, and it informed the International Monetary Fund of its position. However, the Managing Director of the Fund recommended keeping the policy rate unchanged at present, due in part to the uncertainty currently surrounding the Icelandic political scene. The Board of Governors considers it appropriate to take note of this.

In the Central Bank's assessment, as inflation continues to lose pace, it will be possible to lower the policy rate relatively quickly without jeopardising the Bank's exchange rate and price level objectives. It is conceivable that the Bank will declare supplementary interest rate decision dates in addition to those previously announced so as to ensure that the policy rate follows inflation trends and eases downward in suitably small increments. Because of the temporary restrictions on movement of capital to and from Iceland and the adoption of a requirement to submit foreign currency, the link between the policy rate and the exchange rate has been weakened for the present. On the other hand, it is essential to consider this link when contemplating future policy rate decisions, as the exchange rate must have sufficient support from the policy rate when foreign exchange restrictions are lifted.