

## 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 200-300 b.kr. 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 financial 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.