



Icelandic Economic Update

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Long-awaited plan on the table

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The big news in our opinion is not the strategy itself but the government's announcement that **the currency controls could remain in place until 2015** and the impact this statement will have on the interest-rate decisions of the Monetary Policy Committee at its coming meetings, as well as general asset prices in the country.

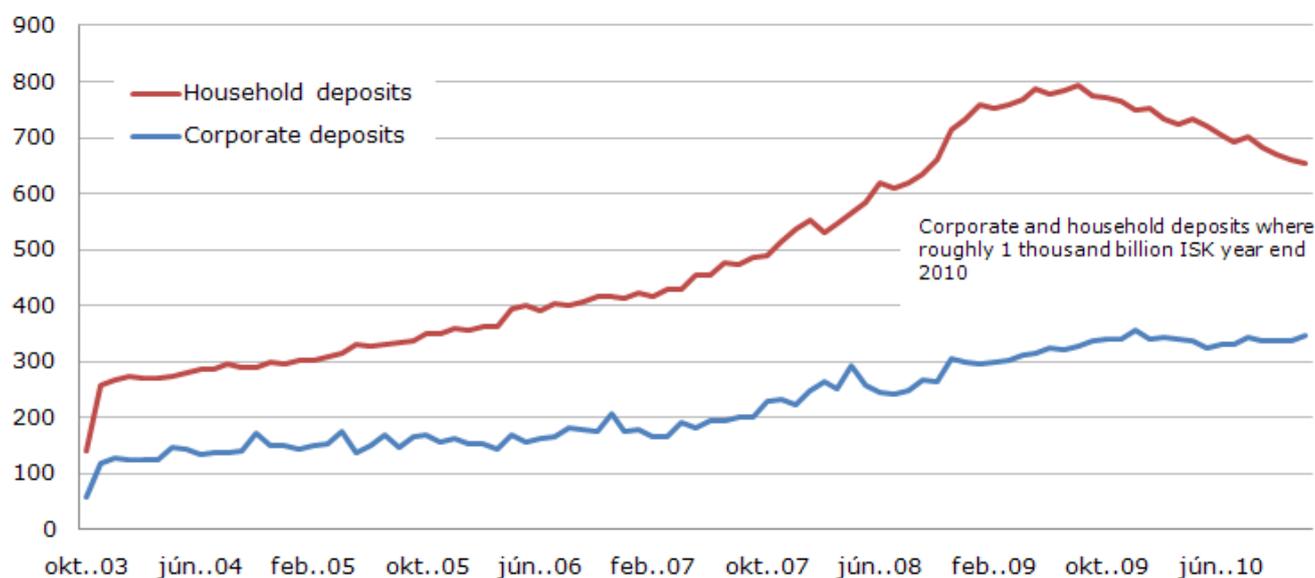
I. A longer wait for lifting of the controls – will interest rates go lower?

If the Monetary Policy Committee had realized from the start that the wait for the lifting of the controls would be as long as it is turning out to be, the interest rate would have been lowered faster and would even have reached an even lower level today. Such speculation is just as relevant now as before and the question that arises is: Will the Central Bank keep lowering the interest rate or will it aim to support the liberalization procedure with high/higher interest rates?

Reasons to keep lowering rates still remain. Most people realize that the currency controls have a hampering impact on investment in the country, and thus economic growth. Therefore, it is good news that the first steps towards liberalization of the controls aim to stimulate investment in the economy by channeling offshore ISK into domestic investment. This is not enough, however, especially with view of the long time frame of the liberalization strategy. The Central Bank's most effective remedy for a weak investment level is to keep lowering the policy rate to bring real interest rates lower. Reasons to keep lowering interest rates still remain as there is substantial slack in the economy (the slack last year having been greater than projected by the Central Bank's economic forecast), inflation is low (especially when excluding rises in commodity prices and taxes) and the ISK exchange rate is relatively stable.

Will the Monetary Policy Committee alter its world view? The Monetary Policy Committee has until now placed great emphasis on maintaining a high interest-rate level, even though conditions in the economy may not have occasioned it. This has been done both to support the short-term ISK exchange rate and to support the pending lifting of the currency controls. We deem unlikely that a major strategic change is underway at the Committee's coming interest-rate meetings.

Corporate and household deposits (ISK billion)



Source: Central Bank of Iceland

II. Asset prices may rise

Arion Research believes that an important uncertainty factor has been eliminated. This new strategy will most likely make a significant impact on asset prices in the country as domestic investors have now “finally” received an announcement from the authorities stating that their money cannot leave the country in the next few years. Therefore, only domestic investment options will be available for domestic parties in coming years. Accordingly, funds are likely to flow increasingly from deposits into other asset markets in coming months and even years – especially as deposit rates are historically low at present. Increased demand for other asset classes, i.e. shares, bonds and real property, should therefore encourage a rise in asset prices.

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