Introduction

Inflation may slow but the current account deficit is a long-term threat to stability

Inflation continued to rise in recent months. The twelve-month rise in the CPI to the beginning of April was 6%, the highest rate in Iceland since the disinflation from two-digit figures came to an end in the first half of the 1990s. This is also a much higher rate of inflation than among Iceland's trading partner countries and might cause a disruption to the stability which has prevailed in recent years if it persists. Inflation in recent months can be traced to general overheating, especially in the real estate market in the Greater Reykjavík Area and rising petrol prices in world markets. More than 70% of the rise in the CPI so far this year can be attributed to residential housing and petrol prices. No end appears to be in sight to the surge in property prices. However, there might be scope for a further reduction in domestic petrol prices, which fell slightly in the beginning of May.

There are virtually no signs that the overheating which has characterized Iceland's economy in the past couple of years is beginning to wane. The growth in deposit bank lending and money supply is still in excess of what is compatible with a low inflation rate. Pressure has continued to build up in the labour market, in particular in the Greater Reykjavík Area, and imports during the first quarter increased considerably from the same period last year.

At the time of writing, wage agreements have been signed which cover some 60% of the general labour market. Assuming that the remaining agreements are modelled on them, they imply an immediate rise in wage costs of almost 5%, further increases of just under 4% at the beginning of 2001 and again in 2002, and a 3% rise at the beginning of 2003. Given the tightness which has prevailed in the labour market recently, the outcome of the wage negotiations may be considered acceptable. The initial wage increase is not far from the assumption underlying the Central Bank's January inflation forecast. Another benefit of these agreements is their long duration, which reduces uncertainty. Nonetheless, they are stretched to the very limit. This year, they entail much larger rises in wage costs than among Iceland's trading partner countries and, all things being equal, will contribute to an even further rise in the real exchange rate. Higher increases in the lowest wages could also fuel wage drift if the economy does not soon begin to cool down. On the other hand, the appreciation of the real exchange rate restricts the scope of export industries and competing industries for meeting further increases in wage costs.

In connection with the wage agreements, the government raised the personal tax allowance this year over and above what had already been decided, and promised to increase it further in the next few years in line with contractual wage rises. These plans entail some, albeit limited, relaxation of the fiscal stance this year, or by less than 0.2% of GDP. However, the rise in personal allowance will be less than the average wage increase in the coming years, and it is uncertain whether it will keep up with inflation. Other points in the government's statement in connection with the wage agreements either refer to decisions which had already been made or to future reforms which should not disrupt the treasury position. Thus the government's contribution to the wage agreements should not cause any significant weakening of to the treasury's position, and have less impact

than the measures accompanying the wage agreements of 1997. Another important point is that the government has much greater scope for deploying taxation as a fiscal instrument now than after the 1997 agreements.

The recent wage agreements could be compatible with decelerating inflation in the coming months and years if the exchange rate remains strong and wage drift does not get out of hand. Inflation will decelerate at a slower rate than would be desirable, however. In order to ensure stability, a continued tight monetary stance is therefore necessary. The Central Bank now forecasts that, assuming an unchanged exchange rate, inflation will be 5% from the beginning to the end of this year, then fall to 4% from the beginning to the end of next year. As always, this forecast is subject to considerable uncertainty, in particular concerning the development of residential housing prices in the coming months and wage drift.

The current account deficit last year turned out to be greater than had previously been estimated, at 6.7% of GDP. In fact, this is to a large extent attributable to accounting changes aimed at bringing the compilation of national accounts into line with international standards. However, this does not alter the fact that the deficit is a serious issue. Such a large current account deficit is almost unparalleled among the developed nations. What makes it even worse is that 1999 was the second consecutive year when a deficit on this scale was sustained, and that it was rooted more in consumption than in investment. Most serious of all, however, is that there is no prospect, in the National Economic Institute's view, of a reduction in the deficit in the next few years, in the absence of policy measures. On the contrary, the current account deficit is forecast to rise beyond 7% this year and head towards 8% after that. The result would be a rise in the ratio of net foreign debt to GDP from 64% at the end of last year to 85% in 2004, and a deterioration in Iceland's net external position from being negative by 49% of GDP to 61%.

Such a large current account deficit is unlikely to be sustained for long without a sharp reversal. The economic imbalance revealed by these projections implies a threat to long-term stability. For this reason, further measures are needed in order to consolidate stability. In this context the most important objective is to promote national saving, either directly through an even larger surplus on public sector operations or by other measures which would definitely promote greater private sector saving. Effective indirect measures towards this end, can however, prove difficult to identify.

Economic imbalances and an exessive rate of inflation call for a continued tight monetary stance. If the recent increase in indexed long-term interest rates proves to be lasting, it will contribute to the cooling of the economy. Further tightening of the monetary stance is also conceivable, but its scope and timing will depend upon an assessment of economic conditions as they unfold.