Introduction

Worse inflation outlook calls for a significantly tighter stance

The inflation outlook has worsened even further since the Central Bank of Iceland last raised its policy interest rate. When the inflation forecast presented here was prepared, the króna had depreciated by roughly 12% from the value assumed in the forecast published in *Monetary Bulletin* at the end of March – at the same time as the Bank raised the policy rate by 0.75 percentage points – and by roughly 6% from May when a further hike of 0.75 percentage points was made. The depreciation has already contributed to soaring inflation and will keep it high over the coming months. The wage review agreed between the Confederation of Employers and Federation of Labour in June will also increase inflationary pressures. For a long while, unit labour costs have been rising by much more than is compatible with the inflation target in the long run. The increments now agreed will add to inflationary pressures which coincide with the peak of the current episode of overheating. This settlement entails large wage rises for the lowest-paid. In the present climate there is a risk that the increases will spread up the pay scale. Real incomes are already at an unsustainable level relative to the production capacity of the economy. The wage rise agreed for July will boost real wages even further in the short run, but the subsequent erosion of purchasing power as inflation outpaces wage growth or employment declines is likely to be all the greater. If the policy rate remains unchanged, the surge in wages is more likely to fuel inflation, first through cost pressures and later via the effect on domestic demand and the exchange rate.

The presentation of the Central Bank's assessment of the inflation outlook in this *Monetary Bulletin* deviates from recent praxis. The baseline forecast is now conditioned on market expectations and financial market analysts' forecasts for the policy rate path, instead of assuming an unchanged policy rate from the day of forecast. On this basis, inflation will climb to almost 11% in Q4/2006, remain in that vicinity until mid-2007 and begin to fall thereafter, but still be far above target at the end of the forecast horizon. According to the baseline forecast, inflation will be roughly 5 percentage points higher half-way across the forecast horizon and 2 percentage points higher at its end than in the forecast published in March. This outlook is unacceptable. However, an alternative scenario entailing a considerably greater rise in the policy rate shows that by tightening the monetary stance the inflation target could be attained roughly two years hence, although the short-term impact will be limited. In the long run, a tighter monetary policy stance does not cause a more pronounced contraction of output, but will expedite the adjustment, generating less inflation with correspondingly less erosion of real wages.

Macroeconomic and inflation forecasting is not a precise science and the results of individual forecasting models must always be interpreted with caution. However, they do give some idea of the possible way that events might unfold. Two eventualities in particular could preclude the need for the policy rate to be raised by as much as the inflation forecast implies. First, the pace of transmission of monetary policy across the interest rate spectrum could accelerate. Second, domestic demand and the output gap could contract more sharply than currently assumed, for example if real estate prices fall by more than is forecast. A tighter fiscal stance can also make a contribution. At present the impact of measures announced by the Government is difficult to assess, but all efforts towards restraint are important.

On the downside, exchange rate developments could turn more unfavourable than forecast. The króna is likely to come under pressure in light of the large current account deficit which is now heading beyond previous forecasts for this year. However, the deficit is forecast to close rapidly over the next two years. A less favourable exchange rate development than expected could lead to even higher inflation, requiring an even higher policy rate to rein it in. The Central Bank will closely monitor these and other indicators that will affect its policy rate decisions in the period ahead.

On the basis of available data, the present monetary policy stance is clearly inadequate for bringing inflation back to target within an acceptable period of time. As it happens, the stance appears to have eased considerably in recent months. Higher inflation expectations have counteracted the 1.75 percentage-point rise in the policy rate this year. In real terms the policy rate is broadly unchanged or lower than at the beginning of the year, depending on the criteria used to gauge it. Relative to past inflation, it has not been lower since the second half of 2004. The króna depreciated sharply in the first half of this year and the impact has already emerged in looser wage developments. Since inflation expectations have increased, the higher policy rate has had little impact on indexed lending rates so far, although developments in recent weeks point in the right direction.

Inflation way above target, a much poorer inflation outlook than in the Central Bank's last forecast and mounting inflation expectations embody a clear message that a considerable increase in the policy rate is still required, although it is uncertain how high the policy rate needs to go in order to bring inflation back to target. In the absence of data indicating that inflation will come down faster than the current outlook implies, the Central Bank will continue to raise interest rates. The Board of Governors of the Central Bank has therefore decided to raise the policy rate by 0.75 percentage points. The Board of Governors has furthermore decided to assess the need for further measures in mid-August and announce a decision on the policy interest rate.