Introduction

Stability cannot be ensured without a struggle

Much water has flowed under the bridge since the Central Bank's last analysis of economic and monetary developments and prospects was published at the beginning of December 2004. On top of the 1 percentage-point hike announced at that time in *Monetary Bulletin* 2004/4, the Central Bank of Iceland raised its policy interest rate by a further 0.5 percentage points this February. The arguments supporting the latter increase were described in a report to the Government of Iceland when inflation breached the upper tolerance limit of the target that month.[1] There are grounds for underlining that inflation above the tolerance limit, which was fairly predictable, did not in its own right warrant the policy rate rise. Rather, the report gave the Central Bank an opportunity to explain its decision, which was made on the basis of an assessment of inflation prospects two years ahead.

Recent policy rate hikes must be seen in the context of surging demand and the deteriorating inflation outlook. Prospects took a significant turn for the worse after the banks began offering mortgage loans on easier terms than before. Fierce competition between the banks and the Housing Financing Fund (HFF) has driven a surge in lending to which no end is in sight. In addition, investment in the aluminium and power sectors has been rescheduled and is now forecast to peak this year instead of 2006.

The Central Bank's policy rate rises, totalling 1½ percentage points since November, have played a part in the more than 10% appreciation of the króna since the end of that month. However, high interest rates are not the only explanation for the strong value of the króna, since historically speaking the policy rate is by no means high in real terms. Export prices have also risen and investments in the aluminium and power sectors are rapidly gaining momentum. As the Central Bank has repeatedly warned, the wave of industrial investments and various other shocks to the economy will inevitably cause a substantial appreciation of the real exchange rate, which has proved a heavy burden for certain sectors of the economy. Since interest rates in global bond and capital markets are close to a historical low, the policy rate in Iceland does not have to be particularly high to create a wide enough interest-rate differential with abroad to attract investors in search of lucrative if somewhat risky short-term investments.

The exchange rate is an important part of the transmission mechanism of monetary policy in an open economy. In the present economic climate, it is an extremely effective channel. Were it not available, monetary policy would be muted by the current global climate in financial markets. For this reason it is important not to

1. The report was submitted to the Government on February 18, 2005 and published on the Central Bank of Iceland website the same day.

obstruct the functionality of the exchange rate channel. Nonetheless, a sharp appreciation of the króna hits the traded goods sector hard and monetary policy offers few remedies. Monetary policy decisions are a general measure aimed at influencing the whole economy, even though this is not always the case in practice because the channels of transmission carry varying weight depending upon the circumstances. A central bank aiming to attain the inflation target that the government has set for it cannot adopt an easier monetary stance than it deems necessary simply out of deference to certain sectors, businesses or households that could suffer from high interest rates or a strong domestic currency. The crowding-out effect of the major shocks that the Icelandic economy is currently experiencing cannot be dissipated by easing the monetary stance. At best this effect would be postponed, probably amplifying the problem later on. The benefits that long-term price stability entails for businesses and households would in that case be sacrificed in favour of narrower interests. At the moment, the economy appears to be fairly resilient to tackle the problems created by the robust króna, even though setbacks will inevitably be felt in some areas.

Monetary policy decision-making should obviously take into account the tighter stance implied by the appreciation of the króna following recent policy rate hikes. In its inflation forecasts, the Central Bank makes the technical assumption of an unchanged policy interest rate and exchange rate over the forecast horizon. The tightening delivered by the appreciation of the króna has therefore been incorporated into the inflation forecast presented in this edition of *Monetary Bulletin.* The forecast suggests that the Central Bank's tighter stance in recent months will have a substantial effect, but still not go far enough. Assuming an unchanged exchange rate, the rate of inflation will slow considerably this year and move down to target for a while, then head back up when the exchange rate effect begins to wane and the positive output gap reaches its peak.

Forecasting is an important tool for the Central Bank in its monetary policy decisions, but not an oracle. The probability that the forecast will broadly hold largely depends on the probability that the assumption of an unchanged exchange rate will hold as well. In practice, this is virtually never the case. The current strength of the króna creates a high probability that it will weaken before the end of the forecast horizon in Q1/2007. Nonetheless, it is conceivable that the króna will appreciate even further before it begins to slip. This appears as an upside risk to the forecast, indicating a high probability that inflation will exceed the forecast, especially further along the horizon.

Last year's current account deficit turned out to be much wider than expected, at the equivalent of 8% of GDP. According to recent indications, it will widen further over the next few months. The outlook is for an even larger deficit this year, equivalent to more than 12% of GDP, assuming that the exchange rate remains unchanged. This is far in excess of earlier Central Bank forecasts and, if it materialises, will be the largest deficit that Iceland has ever experienced. Much of the increase this year can be attributed to larger-than-expected investments in the aluminium and power sectors. To some extent this rescheduling is due to construction work that was postponed last year, but it is mainly because project phases originally planned for 2006 have been brought forward. Investment will therefore peak this year, and not in 2006. Although much of the additional deficit therefore represents more investment, such a large deficit is obviously unsustainable. Even though the deficit will narrow substantially again as early as 2006, aluminium exports will not increase by enough in the coming years to bring it to a sustainable level on their own. In order to restore external balance a sizeable adjustment is required. It seems likely that domestic demand growth and the value of the króna both need to be significantly curtailed. The situation is made even more sensitive by substantial outward investment flows, which makes the current strength of the króna dependent on credit inflows far in excess of what is needed to finance the deficit. External trade imbalances on the scale that lies ahead could undermine long-term exchange rate stability and price stability and ultimately cause a significant contraction. Faced with such a scenario, the only response that monetary policy can resort to is a tighter stance, even though the initial effect may be to drive the deficit even wider.

One of the clearest indications of growing overheating of the economy is soaring housing prices, which are now some way above the previous historical high in real terms. High asset prices are fuelling domestic demand at present and could amplify a recession later, when this is least desirable. While asset price stability is not one of the Central Bank's objectives, it must respond to changes insofar as they impact inflation. It could complicate monetary policy measures next year if the stance needs to be tightened more sharply than is foreseen at present. The ensuing risk of a price slump could weaken the financial system. Financial stability considerations therefore firmly argue in favour of a timely tightening of the monetary stance.

The Central Bank's policy interest rate is currently 8.75%, almost 3½ percentage points higher than at the beginning of May 2004. This is a fairly high rate of interest in international terms, but not in the Icelandic historical context. In real terms the policy rate was much higher when the Central Bank tackled the aftermath of the last episode of overheating a few years ago. The main difference is that at present the króna is floating, which gives the Central Bank leeway for responding earlier than otherwise to signals of overheating. Businesses will feel the effects of the tighter stance at an early stage in the economic cycle, especially in the traded goods sector.

A tighter stance delivers results, even though its effect on certain sectors is undesirably harsh. In the Central Bank's view, further tightening is required to address the robust growth currently forecast and indications of persistent and mounting macroeconomic imbalances. The outlook is that inflation will be above target over the second half of the forecast horizon, even if the króna remains strong, which appears to be an unrealistic assumption. Recent policy rate hikes and the buoyant króna have produced a tightening which still remains to be transmitted in full. In light of these developments, the

Board of Governors of the Central Bank considers it appropriate to raise the policy rate by 0.25 percentage points on this occasion, to 9%. Further tightening may be necessary in the coming months. The traded goods sector will inevitably remain entrenched. Fiscal tightening would be desirable in order to soften the side-effects of tighter monetary measures. This applies to both central and local government. Commercial banks and savings banks are also urged to be prudent in their lending and pay close attention to ensuring safe and well funded loan portfolios, including their mortgage collateral. It may also be necessary to examine whether competition between the HFF and the banks in the mortgage loan market, which has contributed to excessive credit growth at an inopportune time, is being conducted on normal principles, and whether they could not share out their tasks in such a way that will both consolidate the foundations of the domestic financial system and ensure that facilities are available for those who do not enjoy the general degree of access to mortgage borrowing.