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Introduction

Interest rates unchanged for the time being

Inflation has remained marginally below the Central Bank's inflation target so far this year and measured 2.2% at the beginning of May according to the Consumer Price Index. However, it has risen somewhat since the beginning of the year and underlying inflation according to Core Index 1, which excludes volatile components of the CPI, was 2.6% in May. Inflation during the first quarter was marginally higher than the Central Bank had forecast in February, but most other analysts had forecast an even lower rate.

GDP contracted slightly more last year than had been expected, but most indicators strongly suggest that an upswing in domestic demand has resumed, especially in demand for consumer goods, reflecting substantial real wage gains in recent months. Seasonally adjusted unemployment has nevertheless continued to grow; but the labour market is generally a lagging indicator of economic activity. However, the first signs of recovering demand for labour are emerging and will pick up as the year wears on.

The Central Bank's macroeconomic forecast, published in February, incorporated construction activity planned for the Fjardarál aluminium smelter project. The forecast published in this edition of *Monetary Bulletin* also allows for construction activity in connection with the Nordurál aluminium smelter expansion. It should be borne in mind that some uncertainty still surrounds the latter project. These construction activities, public sector investment projects this and following year which were not envisaged in the beginning of February, a probable increase in fishing quotas and the impact of the marked easing of the monetary stance in recent months, have contributed to higher forecast GDP growth this year and in 2004 than in February. However, GDP growth this year is still expected to fall short of output growth potential, at 2½%. Consequently the positive output gap will be further reduced and unemployment will exceed last year's average. In 2004, GDP growth is expected to increase even further to reach 3¼%. This forecast entails that the economy will be in reasonable balance this and the following year.

According to the inflation forecast presented below, which *inter alia* is based on the abovementioned macroeconomic forecast, inflation is expected to remain below the target for most of next year. Towards the end of that year it will head towards the target and then, other things being equal, exceed it in the first half of 2005. The low rate of inflation in the near term is mainly the result of the strengthening of the króna in recent months and lower global inflation than had previously been assumed. The forecast is based on the assumption that wage rises will be relatively modest next year, and much lower than in recent years. Wage cost per man-year is thus expected to rise by only 4½% next year. This is based on the assumption that wage rises will be held in check by the strong exchange rate of the króna and historically high ratio of wages to national income at present. If this assumption fails to hold good and wages rise by more, inflation next year will overshoot the Bank's target, all other things being equal.

The Central Bank last lowered its policy interest rate in February this year and the monetary stance eased even further in the subsequent period. At the beginning of May the policy rate was 2½% in real terms, its lowest level since early 1996. A lowering of the required reserve ratio spurred liquidity supply and contributed to lower yields in the money market. The impact of the eased stance has probably not been transmitted in full to other interest rates and the impetus to domestic demand will continue to be felt well into next year. Furthermore, the interest rate differential with abroad has narrowed and has not been less since September 1996. In spite of this, the króna has been strengthening and was 2% higher in early May than in the beginning of February. Measures taken by the Central Bank in recent months, i.e. cuts in interest rates and the required reserve ratio coupled with currency purchases in the interbank market, serve to bring the exchange rate down, at least temporarily. The recent appreciation of the króna has not been driven by the monetary stance; apparently its roots lie more in expectations aroused by the pending construction projects for power-intensive industry.

The appreciation of the króna represents part of the economy's process of adjusting to the pending construction projects for the aluminium industry. The appreciation which has already taken place will help the economy to absorb these large projects offsetting their inflationary impact and by restraining economic growth in the period leading up to them. However, the stronger exchange rate hits exporters and competing industries and has already caused their profitability to decline. However, it should be borne in mind that the gross profits of a large part of the export sector was at a historical peak in 2001 and 2002. Nevertheless, the effect that further appreciation of the real exchange rate will have on these industries is a cause for concern. As described in the following chapter, in the current climate a cut in Central Bank interest rates would only have a short-lived effect on the exchange rate, if any. The same would apply to interventions in the foreign exchange market and changes in the composition of the treasury's foreign and domestic debt. Furthermore, an interest rate cut at present would not be compatible with the Bank's inflation target. Other measures are therefore needed in order to contain an undesirable rise in the real exchange rate. One of the most effective would be to tighten the cyclically adjusted fiscal stance, in particular by cutting back public sector construction activities when activity connected to the aluminium projects reach a peak. Such measures would dampen domestic demand and lead to a lower real exchange rate than otherwise. Likewise, labour supply should be boosted during the construction phase by employing more foreign labour. This would alleviate pressure in the labour market and moderate the resulting rise in the real exchange rate.

Given the current climate and outlook, it would be highly imprudent to ease the fiscal stance further, since this would increase the hardship to export and competing industries by contributing to an appreciation of the króna. On the contrary, it is important to let automatic fiscal stabilizers work to full extent, refraining from using higher revenue to fund expenditure increases or tax cuts. Given the probability of a slight public sector deficit this year, tax reductions in the next few years will call for expenditures cuts.

It is always preferable if fiscal and monetary policy can work in harmony. This will be even more important than usual in the coming years if economic stability is to be maintained and inflation kept close to target without excessive disruption to the export sector. Since expectations have recently had a major impact on the exchange rate, there is a strong case for a credible fiscal strategy, extending over a period of several years, which is aimed at counterbalancing the impact of the construction activities. These would moderate any further appreciation of the króna and the need for a very tight monetary stance. Thus it is crucial to design and announce a credible fiscal policy strategy as early as possible.

Monetary and fiscal policy must reinforce each other in the forthcoming phase. The Central Bank is prepared to cooperate in this respect, as was emphasised at its annual meeting in March. Nonetheless, such cooperation must be based on the principle that monetary policy at any time must be consistent with the Bank's inflation target.

The Governors of the Central Bank have decided to increase its daily purchases of foreign currency in the domestic interbank market to 2.5 million US dollars as of May 19. Since beginning regular currency purchases in September last year the Bank has bought the equivalent of 12.8 b.kr. under this arrangement, in addition to one trade to the equivalent of 4 b.kr. In August 2002, when the plans to purchase currency were made known, the Bank announced that it intended to buy the equivalent of 20 b.kr. before the end of 2003. Since then, conditions have changed sharply. Currency inflows and the strong króna following the decision to construct an aluminium smelter and hydropower facilities in East Iceland present an opportunity for further currency purchases, which the Bank intends to take advantage of in order to further strengthen its foreign reserve. The reserve is an important factor for the credit rating of the Republic of Iceland and other domestic entities. This measure may obviously have an effect on the exchange rate, at least in the short run, and will also increase liquidity in the financial system. It is described in more detail in the chapter on Financial market developments and Central Bank measures.

As usual in the May *Monetary Bulletin*, an article is included on financial stability. Its main findings are that macroeconomic conditions for financial stability have improved even further since the last analysis was published in November 2002. Low inflation, moderate interest rates and comfortable external balance should contribute to a favourable environment for households and corporations. The position of commercial banks and savings banks has strengthened. Profitability is excellent, their cost ratio has come down and defaults appear to be on the decline, but non-performing loans are still increasing. The equity ratio rose last year for the second consecutive year. Risk management is being strengthened in payment systems, which has resulted in better liquidity management by credit institutions. Stronger credit ratings have been awarded to the Republic of Iceland and rated financial companies.

In light of the inflation forecast presented in this *Monetary Bulletin*, the Governors of the Central Bank do not see grounds for altering interest rates at present. Although the outlook is for inflation to remain below the Central Bank's target in the near future, it will be around the target two years hence and gaining momentum as construction activity intensifies. Monetary policy will be increasingly conditioned by the pending large-scale projects as they draw closer. The forecast presented here implies that interest rates can remain unchanged for a while but will then enter an upward phase. The timing and scale of these hikes will be determined not least by the stance of fiscal policy. However, it should be underlined that monetary policy will respond to the unfolding economic developments and unexpected changes which could affect its implementation can never be excluded.