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Ladies and Gentlemen

The Board of Governors of the Central Bank of Iceland decided yesterday to raise the policy interest rate by one percentage point, from 7.25% to 8.25%. I shall use this opportunity to explain that decision and of course to discuss the economic and monetary situation and prospects, including the Bank's new macroeconomic and inflation forecast.

Long-term inflation prospects have taken a turn for the worse since the Central Bank of Iceland published its last inflation forecast in June this year. In particular this is the result of greater-than-expected growth in domestic demand. Several factors may be pointed out which I shall discuss in more detail.

GDP growth is and will be greater than was forecast in June. Tougher competition in the credit markets has resulted in much easier household access to credit and lower long-term interest rates on mortgage lending. Consequently, lending to households has surged, which in turn has driven up housing prices. Planned investments for the aluminium industry have been stepped up even further and are more concentrated over the next two years than was previously foreseen. Declarations of pending tax cuts have been confirmed and plans to tighten public sector expenditure over the next two years are rather vague. The outlook is that these conditions will result in a far larger positive output gap than had been foreseen, which unless appropriate action is taken will fuel inflation, especially in 2006. A review of wage agreements is more likely to be triggered if inflation cannot be brought under control.

Maintaining price stability is one of the Central Bank's chief mandatory tasks and the inflation target is 2½%, measured as the twelve-month rise in the CPI. Inflation has been heading upwards in recent months and the twelve-month rate of increase in the CPI measured 3.8% in November. This is the seventh consecutive month that inflation measures more than 3.5%. Statistics Iceland publishes two indicators of underlying inflation. The rise in Core index 1 (the CPI excluding agricultural products, vegetables, fruit and fuel) measured 3.3% in November, and has been 3% or above for the past seven months. Core index 2, which furthermore excludes changes in prices of public services, rose by 3.1% over the twelve months to November, and the annualised increase has hovered around 3% for the past seven months as well.

Inflation is still confined to relatively few components. Most of the increase in these components is driven by demand, but part by direct cost pressure. The clearest indicator of demand pressure is the sharp rise in housing prices in the recent term. Of the 3.8% rise in the CPI over the past twelve months, 1.3 percentage points are explained by the housing component. Some 0.6 percentage points of the increase in the CPI are explained by higher petrol prices, which are transmitted quickly from global markets to domestic prices. The rise in public services prices has also outpaced CPI inflation as a whole. More than two-thirds of inflation over the past twelve months is attributable to higher prices of housing, petrol and public services. Excluding these components, price increases have been moderate. In the beginning of November the twelve-month rise in private sector services was 2.3%, in imported goods excluding alcohol and tobacco 2.5% and in domestic goods excluding agricultural products and vegetables 1.6%.

Increases in market prices of housing have continued almost unabated since April and when the impact of tougher competition in the housing loan market and lower mortgage interest rates began to filter through in early autumn, housing prices rose strongly. In November, the twelve-month rise in the housing component of the CPI had reached 8.8%, driving the CPI up by 1.6%.

Housing prices have risen fastest in the Greater Reykjavík Area over the past twelve months, but have also increased considerably in regional Iceland. The sharpest increases have been in detached housing and larger residential properties, at just over 20% over the past twelve months, compared with 12% for apartments over the same period. In the past four months, prices of larger residential housing have increased particularly briskly, averaging 2-3.5% per month.

In its recently published macroeconomic forecast, the Central Bank has made a sizeable upward revision to the forecasts for domestic demand and GDP growth over the next two years. Let us examine each of these aggregates separately. In June the Central Bank forecast 5½% growth in private consumption in 2004. The outlook now is for a considerably larger increase. Private consumption grew by 7.2% year-on-year in the first half of 2004 and growth of 7% is forecast over the whole year. On a two-year horizon, it seems beyond doubt that private consumption will continue to grow rapidly. Private consumption is forecast to grow by 9½% in 2005 and just under 7% in 2006. Many factors are at work. Households have responded promptly to the banks' mortgage loans and most indicators suggest that they will continue to refinance their debt in the years to come and lengthen the maturities of their outstanding debt when they do so. The repayment burden on outstanding debt will therefore ease considerably. Households will be left with more disposable income after debt service and probably spend most of it on private consumption. Tax cuts will presumably have the same effect. In addition, households are likely to respond to their easier debt service burden with increased borrowing.

Public consumption looks set to increase by roughly 1½% this year, broadly in line with the assumption in the Ministry of Finance's national budget from the beginning of October. This figure incorporates the effect of the teachers' strike, which will reduce public consumption expenditure in 2004 and increase it in 2005. According to the budget proposal for 2005, underlying public consumption growth will amount to 2%. The Central Bank forecast assumes that public consumption will grow by 2.5%, rather more than the 2% estimated in the budget proposal. Growth will be divided between 3.0% for local government and 2.3% for central government. One reason for deviating from the budget proposal assumptions for underlying public consumption growth is that expenditure figures for the year seem to indicate that both outlays and revenues will overshoot the estimates made this autumn. It may be pointed out that public consumption growth has tended to be underestimated at this time of year in the past, by an average of 1.2% over the period 1998-2003. Thus the Central Bank forecasts that public consumption will increase by just over 3% in 2005 and 2½% in 2006. If the Ministry's estimates hold, as we surely hope, GDP is likely to be half a percentage point less in 2005, but the effect in 2006 will be less. Annual inflation over the next two years would then be in the range 0.2-0.3 percentage points lower than otherwise.

Growth of gross fixed capital formation is firmly shaped by the increasing momentum behind investments in power stations and the aluminium industry. In June the Central Bank forecast that gross fixed capital formation would increase by 17% in 2004, which appears likely to hold. In the first half of 2004, gross fixed capital formation grew 19% year-on-year. The rate in Q3 was probably broadly the same, although the increase in imports of investment goods has slowed down. Public sector investment has been clearly shrinking over the course of the year and the current forecast assumes a contraction in the second half. Business investment, on the other hand, is soaring, due to construction of power stations. Most indicators also suggest that residential housing investment will increase by at least as much as in 2003. The Central Bank forecasts that total investment will grow by more than 20% in 2005 and almost 3% in 2006. Next year's investment level is far higher than was forecast in June, while the figure for 2006 is somewhat lower. More investment in 2005 is largely the result of rescheduling and new plans for aluminium-related projects, and of increased housing investment, partly driven by the new domestic mortgage market climate and its impact on housing prices, which provide a further stimulus to invest. The lower investment level in 2006 than forecast in June is primarily caused by the higher level next year, which reduces year-on-year growth.

According to the Central Bank's forecast, output growth will be roughly 5½% this year and just over 6% next year, then slow slightly to just under 5% in 2006. Thus the outlook next year is for the highest rate of output growth since 1987.

The macroeconomic forecast for 2004-2006 implies a wide and growing current account deficit. It is forecast to widen further from 6½% of GDP in 2004 to 10½% in 2005 and 11½% in 2006. Naturally this will be accompanied by heavy debt accumulation. Iceland's external debt will increase considerably over the period, to the equivalent of 112% of GDP at the end of 2006. An estimated 40-50% of the current account deficit over the period can be attributed to investments for the aluminium industry. New smelters will cause aluminium exports to surge. In 2008, when all the investments incorporated into the forecast are completed, aluminium exports will be around 165% higher in volume terms than this year. In rough terms, aluminium exports will amount to almost 100 b.kr. in 2008, increasing by around 60 b.kr. from this year's probable figure. Naturally this will help the current account balance to improve when the ongoing investments in smelters and power stations are completed.

Growth over the next two years will obviously be well beyond the production capacity of the economy. According to revised assessments of demand and production capacity in recent years, the estimated output gap has been revised downwards to 1½% in 2001 and the slack in 2002 to 1½%, closing completely in 2003. A new period of expansion began this year. On the basis of the assumptions in the macroeconomic forecast, including an unchanged exchange rate and policy rate, the economy is heading for a substantial positive output gap over the next few years, at almost 2% in 2004, almost 4% in 2005 and roughly 5% in 2006. The role of the output gap forecast two years ahead is to be able to assess the demand impulse to inflation. Given the heavy investments for the aluminium industry at the same time as household credit has become much more accessible, the wide output gap shown here appears quite plausible. A tighter economic policy stance than assumed in the forecast, which the Central Bank has already applied with the policy rate hike announced yesterday, will narrow the output gap and thereby ease inflationary pressures.

Now I shall turn to the Central Bank's inflation forecast. I want to underline that, as always, the forecast assumes an unchanged exchange rate, which was now based on an exchange rate index value of 120, and an unchanged policy rate, i.e. the rate that was in effect in November. The forecast indicates first and foremost what the inflation rate would be if the Central Bank made no response – it is therefore an instrument that the Bank uses to decide the policy interest rate. Inflation is forecast to be above target across the entire horizon, and move beyond its upper tolerance limit at the end. The outlook is for average inflation of 3.2% in 2004, in line with the June forecast. Average inflation next year is forecast at 3.4%. Inflation in 2006 is forecast at 3.5% on average, but almost 4.5% over the year. The main driver of inflation over the next two years is growing domestic demand which will increasingly widen the output gap, i.e. production in excess of long-term potential. However, I want to stress one more time that the Central Bank's decision yesterday to raise the policy rate is aimed at preventing the development indicated in the forecast from actually materialising. It aims to contribute to putting inflation back on target.

I shall now devote a few words to the surge in credit in recent times, which has exceeded a level compatible with long-term price stability. Lending by the credit system as a whole grew by 15.4% over the twelve months to the end of June. Data for the credit system as a whole until the end of September are not yet available, but an approximation of the growth rate can be obtained by adding lending figures for the deposit money banks (DMBs), Housing Financing Fund (HFF) and pension funds. At end-September their twelve-month lending growth was 22%. Lending to the corporate sector showed particularly rapid growth, having increased by more than one-fifth at the end of June and by almost one-third at the end of September. Lending to households has also soared over the past two quarters. Annual growth in combined household lending by DMBs, pension funds and the HFF amounted to 14% at the end of September. Data for DMB and HFF lending are available until the end of October. Domestic lending by DMBs grew by more than 7% over the month and one-third over one year. To some extent, the increase in DMB lending is at the expense of the HFF, and perhaps the pension funds as well, although no data are available for the latter's lending in October. At the end of October, combined DMB and HFF lending had increased by slightly less than 23% in the space of a year.

Now I would briefly like to discuss a change in the Central Bank's policy on currency purchases. Since the beginning of September 2002 the Central Bank of Iceland has made regular purchases of currency in the interbank forex market with the sole aim of boosting its foreign exchange reserve, which had been severely depleted by the Bank's intervention in the market in 2000 and 2001. From September 2002 until the end of 2004, currency purchases will probably have totalled 75 b.kr. and the reserve is likely to be around 70 b.kr. at the end of the year. The Central Bank does not see grounds for boosting its reserves further for the time being. It has therefore decided, from the beginning of 2005, to cease regular currency purchases with the aim of strengthening its reserves. After that the Central Bank will only purchase currency in the domestic forex market to fulfil the Treasury's requirements for foreign debt service. Accordingly, in 2005 the Bank will purchase 2.5 million US dollars once a week in the market. The Central Bank will purchase currency on behalf of the Treasury for its foreign debt service requirement beyond these currently scheduled amounts and give forex market makers advance notice of transaction arrangements.

Finally, I want to address monetary policy. The policy rate hike that has now been decided is certainly exceptionally large. It must be seen in the context of recent rapid changes in the credit market and the approaching peak of investment in power stations and aluminium smelters, which according to revised plans will be reached faster and sooner than previously estimated. Another consideration to bear in mind is that, in spite of five rises in the policy rate totalling almost 2 percentage points from May to November, in real terms the policy rate in November (measured against the breakeven inflation rate on non-indexed Treasury bonds) is only marginally – if at all – higher than the natural real rate of interest, i.e. the real rate that is compatible with macroeconomic stability on average across the business cycle. Inflation expectations have been unacceptably high and have dampened the effectiveness of the Central Bank's policy rate rises. This, in turn, may have served to push inflation expectations higher. By raising its policy rate by more than usual in a single step, the Central Bank aims to ensure a higher expected real policy rate, through the dual effect of higher nominal interest rates and lower inflation expectations. This reflects the Bank's commitment to maintain a sufficiently tight monetary stance to contain inflation when the investments for the aluminium industry gain even more momentum. Claims which have occasionally been heard, to the effect that the Central Bank's monetary policy instruments have become impotent, are based on a misunderstanding. While the transmission mechanism of monetary policy may have changed, it is still in place and monetary policy will have the intended effect.

On the assumption of an unchanged policy rate from this November, the outlook was for a rate of inflation well above the 2½% target in the period leading up to the review of national wage agreements in November next year. The inflation outlook over that period has taken a marked turn for the worse since the last forecast. If high inflation triggers further wage increases, prospects for 2006 will deteriorate still further, which could make more rate hikes necessary that year. In order to have a sufficiently swift impact on inflation over this period, a prompt and timely response is needed. In the current scenario, the Central Bank is likely to raise interest rates even further in the coming months.

Ladies and Gentlemen

In the next few years, monetary policy will face conditions that seriously challenge the adaptability of the economy. An effective monetary and fiscal policy mix is vital in such a climate. The greater the burden that monetary policy has to bear over this period, the more negative its side-effects. The Central Bank has firmly underlined that monetary policy should be backed up with a tight fiscal policy stance and from the public sector as a whole. The fiscal budget proposal for 2005 implies some tightening from the previous year. Nonetheless, the cyclically adjusted Treasury balance in 2005 and 2006 will be considerably weaker than during the episode of overheating in 1999 and 2000. The stance at that time proved to be insufficiently tight, as became clear in the aftermath in 2001 and 2002. Counteracting the impulse provided by tax cuts over the coming years calls for sizeable cuts in central government spending, which undoubtedly will meet with resistance. The vague nature of plans announced for cost restraint is therefore a major cause of concern. Public sector expenditure tends to overshoot the budget targets in most years. Monetary policy can not afford to take the realisation of ambitious plans for cutbacks for granted. If they fail to be realised, it may be too late to respond, given the circumstances that lie close ahead. The Central Bank must base its monetary policy measures on what it considers to be the most probable scenario. It was on these grounds that the Bank raised its policy interest rate now and is ready to increase it further in order to put inflation back on track towards the 2½% target as soon as possible.