Introduction

Interest rates unchanged for the time being

Inflation has proved to be higher and more persistent in recent months than had been hoped. Measured as the twelve-month rise in the CPI, inflation escalated in 2001 and finished at 9.4% from the beginning to the end of the year. In the fourth quarter, inflation was somewhat higher than the Central Bank had forecast in November, although the deviation was well within statistical confidence limits. Quarterly inflation forecasts have been too low ever since February last year. The main reason is that the króna weakened almost continuously from the middle of 2000 until early December 2001, while the Bank's forecasts have assumed an unchanged exchange rate from the day of the forecast until the end of the forecast period. Both the exchange rate depreciation and inflation itself, however, are rooted in the excessive expansion of demand which occurred from 1998 to 2000, and in wage rises far in excess of productivity growth which continued at full pace in 2001.

The exchange rate of the króna depreciated following the Central Bank's 0.8% cut in its policy rate on November 8, and reached a low on November 28. By then it was almost 4½% lower than had been assumed in the inflation forecast published by the Bank in November. Good news about foreign trade and profitability of export sectors towards the end of November, and later an agreement between employers and unions to postpone an inflation-triggered review of wage agreements, reversed this trend. Boosted further by a decision to increase fishing quotas, by the end of January the króna was almost 8% stronger than at its lowest point in November. The foreign exchange market has been in much better balance in recent weeks than for most of last year. One sign of this is that a surprise 0.9% rise in the CPI in January caused only very temporary tremors. The strengthening of the króna in recent weeks means that the inflation forecast published in this issue of *Monetary Bulletin* is based on a higher exchange rate than the last forecast. This is the first time since May 2000 that the exchange rate reference has gone up when a new inflation forecast is made.

Recent reforms to the markets that the Central Bank operates on have probably led to a better balance and more moderate fluctuations in the foreign exchange market. An interbank currency swap market has been set up which, it is hoped, will contribute to more effective intermediation of liquid funds and a more meaningful yield curve in the interbank markets. The Bank has also traded off-market with foreign exchange market makers in special and exceptional cases. Last year, Central Bank repos compensated for the negative effect on liquidity which resulted from Central Bank interventions in the forex market and to some extent also from the rise in credit institutions' required reserves. Individual institutions should therefore be able to meet their liquidity requirements within the current system, without the need for any special measures on the part of the Central Bank.

As pointed out in previous issues of *Monetary Bulletin*, the Central Bank has been of the view that the exchange rate of the króna had fallen significantly lower than economic fundamentals warranted. In November, in the Bank's assessment, there were grounds for a significant strengthening. The exchange rate trend shifted in the beginning of December, and the Bank considers that this pattern is likely to continue in the near future. Estimates suggest that this year's current account deficit will be even smaller than forecast in December, or in the range of 4% to 4½% of GDP. The Bank's surveys also indicate that the commercial banks, the main power company, municipal authorities and public sector funds plan net borrowing abroad this year in excess of what is needed to finance the current account deficit forecast for 2002 and the outflow on direct and indirect investments. This is based on the assumption that pension funds and other players will restrain their foreign investments in the near future. All things being equal, financing of this year's current account deficit therefore seems to be forthcoming, irrespective of whether there will be a special foreign borrowing operation by the treasury .

In the longer run, the strength of the króna depends on the success in bringing down inflation and domestic cost increases. The agreement between the Federation of Icelandic Labour and Confederation of Employers from December 13, postponing until May an inflation-triggered review of wage agreements, was a positive step towards dispelling wage and price uncertainty and thereby strengthening the basis for a higher exchange rate. It reduced the likelihood of a wage, exchange rate and price spiral, which has been one of the greatest threats to attaining the inflation target in the near future. Concerted direct actions aimed at ensuring that the price index target agreed by the unions and employers will be reached in May, despite a large rise in the CPI in the beginning of January, may help to bring down prices temporarily and/or speed up the impact of a stronger exchange rate. However, these measures do not have any major long-term effect on inflation, which is determined by the monetary stance in conjunction with demand in the economy.

According to the inflation forecast published in this issue of *Monetary Bulletin*, inflation prospects for this year have improved since November. Inflation of 3% is forecast over the year, compared to just over 4% in November. The reasons for this decline in forecasted inflation this year are the appreciation of the króna and the outlook for lower prices in international trade. Offsetting this to some extent are greater than expected wage drift last year and expected cost increases following the labour market agreement in December. According to the forecast, it is rather unlikely that the price level target set in the wage agreements for May of this year will be attained. However, the overshoot will be small and the target could be achieved if the exchange rate strengthens further and/or specific measures to reduce prices produce significant results. The inflation outlook for next year, however, has worsened somewhat, all things being equal. This is caused by changes in international trade prices which are forecast to rise again when the global economy picks up, and by the outlook for somewhat larger increases in wage costs than previously assumed. Inflation will be in the region of 3% until the end of the forecast period, and the Central Bank's target for 2½% inflation in 2003 will not be achieved without a change in some of the assumptions made in the forecast. Another cause for concern regarding the inflation outlook for this and next year is that statistical models based on the long-term relationship between inflation and cost factors, and incorporating output gap developments, suggest that disinflation could be a slower process than is assumed here. In the current scenario, it would seem to call for a further currency appreciation or a greater slack in the output gap than is now foreseen in order to achieve the target of 2½% inflation next year.

The Central Bank of Iceland is of the view that, in light of the circumstances, there are no grounds for cutting interest rates for the time being. Inflation has been running high recently. It is vital not to weaken the exchange rate of the króna, in order to enhance the likelihood of attaining the price level target in wage agreements and the Central Bank's inflation target. There are indications that economic growth last year was higher and that the contraction of GDP this year will be smaller than forecast in December. The output gap will therefore slacken more slowly than was assumed before. Furthermore, the inflation forecast indicates that a fair degree of monetary restraint must be kept in the near term. However, the underlying assumptions could change fairly quickly. Exchange rate and price developments in the weeks and months to come will be an important factor in that respect.