Introduction

Inflation outlook and contraction create scope for cutting interest rates

Inflation has been on the decrease in recent months. The exchange rate of the króna has appreciated in step with the rapidly decreasing current account deficit. At the same time, domestic demand has continued to contract and the outlook is for some contraction in GDP this year, after a long period of robust growth. The overheating that prevailed in the goods and labour markets has rapidly dwindled and is likely to be turning into slack at the present time. These conditions are favourable with regard to reducing inflation but represent a difficult adjustment for businesses and households which could affect the financial system.

Inflation during the first quarter of the year was slightly lower than the Central Bank had forecast in its last *Monetary Bulletin*, which is explained by special government measures and the effects of changes made in the CPI base. Excluding these factors, the forecast would have been too low. Nonetheless, underlying inflation has declined sharply, as predicted last time by the Bank. After adjustment for the above factors, underlying inflation can be estimated to have been 4% during the past three months, which is a much lower rate than in the second half of last year. Coupled with the higher exchange rate of the króna, this development makes it highly unlikely that the CPI will exceed this May's targets set by the partners on the labour market which would trigger a review of wage agreements.

There are an increasing number of signs that the overheated economy has been rapidly cooling down and that some slack may even have emerged already. While the positive output gap previously played a significant part in escalating inflation, slack will help to contain it. In this context, developments in the labour market are crucial. There are indications that wage drift in the general labour market has virtually come to a halt and could have turned negative in some sectors. Cyclically adjusted unemployment is also increasing by the month, people are working fewer hours and the participation rate is falling.

In its last inflation forecast, the Bank did not expect its inflation target to be met in 2003, given the assumptions. Together with a high inflation rate during the months before the forecast was made, this reduced the scope for the Bank to counteract the contraction by cutting interest rates. However, it was pointed out that the assumptions could change relatively quickly in this respect, especially if the exchange rate of the króna strengthened further and/or the positive output gap closed more quickly than had been assumed. This turned out to be the case. The inflation forecast presented here is based on an exchange rate just over 5% higher than the previous forecast, and assumed wage drift has been lowered. The outcome is that the Bank's target of a 2½% rate of inflation will be attained during the closing months of 2003. In the first half of 2004, inflation will be below the target, given an unchanged monetary stance. Inflation will move within the upper tolerance limit of the inflation target, which is currently 4½%, as early as the third quarter of this year.

In the last *Monetary Bulletin*, the Central Bank presented estimates that flows in the foreign exchange market this year would support a further strengthening of the króna. This was based on the outlook that the current account deficit would shrink substantially to 33 b.kr., outflows on direct and indirect investments would contract significantly, and that planned external borrowing appeared to be more than was needed to finance outflows on account of these factors. This has been borne out. The exchange rate has appreciated significantly recently. By the end of April it was almost 6½% higher than at the end of January. Developments so far this year have confirmed the outlook for a much smaller current account deficit. The fundamentals for the stronger exchange rate are therefore still in place.

Recent developments confirm the Central Bank's assessment that last year's depreciation of the króna was from a long-term perspective more than the fundamentals warranted. Of course, the slide of the króna was based on market factors, given the currency outflow caused by the current account deficit and unfavourable expectations. However, the deficit could and surely would have narrowed without the króna depreciating as much as it did. It is well known that exchange rates tend to overshoot their medium term equilibrium level when they undergo a quick reversal. Thus last November the Bank was of the opinion that the real exchange rate of the króna would rise in one way or another, having fallen to 15% below the ten-year average in the last quarter of 2001, and even lower compared with a longer period. It is important for the inflation outlook that the rise in real exchange rate in the most recent months has been prompted by a higher nominal exchange rate rather than more inflation. The exchange rate at the end of this April was marginally higher than at the end of April last year. The real exchange rate has gone up by more, however, due to higher inflation than among trading partner countries. According to current estimates it will be 5½% higher during the second quarter than a year before. However, it remains some way below the average for the past ten years.

The time may come when the Central Bank might opt to take advantage of further currency inflows to boost its external position. Under the current circumstances, however, the Bank's priority is to attain its inflation target. A great deal of uncertainty surrounds where the equilibrium exchange rate of the króna lies at any time. One of the advantages of inflation targeting is that the monetary authorities do not need to form an exact view on the equilibrium exchange rate. But it is difficult to infer that the exchange rate of the króna has already surpassed its equilibrium rate. In this context it should be borne in mind that the roots of the shrinking current account deficit lie not only in the falling exchange rate. The following factors can also be pointed out: First, the decline in domestic demand caused by high interest rates and greater indebtedness; second, saturation as a result of the preceding wave of investment and purchases of consumer durables; and third, export growth in sectors such as fisheries whose production volume is not particularly sensitive to exchange rate changes.

A half-yearly analysis of financial stability is published in this issue of *Monetary Bulletin*. External macroeconomic balance has improved significantly with the smaller current account deficit and the fact that the challenge posed by the exchange rate shock is over. The financial system has not suffered a substantial negative impact from the adjustment so far. On the contrary, credit institutions have managed to strengthen their positions. The financial system turned out to be in a better position than suggested by the outlook last year. However, it should be borne in mind that the good profitability of many credit institutions is to a considerable extent the result of temporary factors. Thus it is important for them to remain on the alert, since they may conceivably still sustain loan losses in the wake of rapid credit expansion in recent years, especially in view of high indebtedness and debt service burden among businesses and households. An economic contraction this year and rising unemployment could also relay further challenges to the financial system. On the whole, however, there is even more reason now than last year to expect that the financial system will be able to manage on its own any difficulties that may lie ahead.

The apparent success achieved in restoring stability and bringing inflation down to a low level is primarily the result of the tight monetary stance that has been adhered to in recent times. High interest rates have reduced investment and private consumption, which in turn has contributed both to reducing the current account deficit and establishing better balance in the labour market. The consequence has been that wage drift has halted and businesses will have to increase productivity and cut costs instead of putting up prices. Yet again, this goes to prove that inflation is in the final analysis a monetary phenomenon. The initiative of the partners on the labour market took place within this framework in the sense that the tight monetary stance contributed to lower inflation, making it difficult to seek wage rises in order to compensate for previous price rises. This does not alter the fact that this initiative was extremely important and undoubtedly promotes faster disinflation, and probably ultimately less cost in the form of lost economic growth and unemployment, than would otherwise have been the case.

The Central Bank has now lowered its policy interest rate twice in a short time, by a total of 0.8 percentage points. In spite of these reductions, the monetary stance remains tight when measured in view of inflation expectations and forecast inflation. In light of the emerging slack, it would be desirable for Central Bank interest rates to continue to go down in the months to come. The Central Bank's main objective, however, involves maintaining inflation around a rate of 2½%. The current inflation forecast suggests that conditions will soon be in place for a further cut in the Bank's policy interest rate. The next step is linked to the price target this May set by the labour market partners. If all uncertainty can be dispelled as to whether current wage agreements will remain in force, the Bank will in all probability cut its interest rates soon afterwards.