Introduction

Conditions still in place for easing the monetary stance

Inflation has been decelerating rapidly in the past few months. The Central Bank's inflation target was attained in November 2002. The core indices which measure the underlying inflation rate were still at that time above the target, but moved below it in January. As expected, the twelve-month rise in the Consumer Price Index (CPI) slowed down further and measured only 1.4% in January. This was partly the result of a large rise in the CPI in January 2002 and the twelve-month rate will be higher in the next few months. Inflation in the fourth quarter of 2002 was in line with the Central Bank's forecast from November. The Bank forecast then that consumer prices in Q4/2002 would be 2.3% higher than a year before, while the actual figure turned out to be 2.2%.

Output and demand have shown a rather weaker development than had been expected earlier in the winter. GDP shrank significantly in Q3/2002 compared with the same period a year before, and there are indications that it grew little in the final quarter. For the year as a whole GDP is thus now estimated to have contracted slightly from the year before. The labour market has as well continued to weaken, and there are signs that demand for labour will drop even further, with rising unemployment during the first months of this year. This greater slack has an impact on the Central Bank's new national economic forecast. The main change from the Bank's last forecast, however, is that it now allows for the construction of an aluminium smelter in East Iceland and the associated hydropower facilities. Another factor affecting the forecast is that it is based on the exchange rate towards the end of January, which was almost 5% higher than assumed in the November forecast and that total allowable fish catches have been increased.

On the basis of these assumptions, GDP growth is now forecast at 1¾% this year and 3% in 2004. In spite of the aluminium related investment projects, this is only a marginally higher growth figure this year than had been forecast in November, and the same for next year. The reasons for this include greater slack at present than was foreseen then and a higher exchange rate. But it should also be borne in mind that the bulk of work for the power-intensive industrial project will not take place until 2005 and 2006. Overall, the economy will be in fairly good balance for the next two years, according to this forecast. The current account deficit, for example, will be well within sustainable limits despite imports of investment goods for the power-intensive project. Although there will be some slack in the economy in the months to come, taking the form among other things of forecast average unemployment of 3½% this year, it will be relatively small, and next year unemployment will come down while the positive output gap will remain small. On these assumptions along with an unchanged exchange rate and monetary policy stance from the end of January, inflation is now forecast at just above 2% this year and next year, i.e. slightly below the Central Bank's inflation target.

The current edition of *Monetary Bulletin* includes the Central Bank's analysis of the proposed investment in the aluminium sector and related power plants in east Iceland. This is a very large project relative to the size of the Icelandic economy and will increase the positive output gap and inflationary pressures, especially in 2005 and 2006 when 2/3 of the investment will be made. Without any internal response by the economy, e.g. a strengthening of the exchange rate of the króna, or any economic policy response, there is a significant probability that inflation will move considerably outside the tolerance limits of the inflation target. The study nonetheless suggests that, with appropriate economic policy responses, it will prove possible to contain inflation well within the tolerance limits when it peaks. In the absence of any exchange rate adjustment and fiscal action, however, monetary policy will come under great strain. Thus all other things being equal, the Central Bank's policy interest rate could need to go up to at least 10% at its peak. An exchange rate adjustment and effective fiscal measures could substantially reduce the need for raising the policy rate, which would under such conditions not need to go any higher than just over 7%. For monetary policy to be sufficiently forward-looking, interest rates would need to go up above what they would otherwise have been next year at the latest, but exchange rate developments could have some effect on the timing. In fact, there are many indications that part of the conceivable adjustment of the exchange rate due to this project has already appeared.

Major reservations must be made about the results of these calculations. They are based on diverse assumptions which may fail to hold good, such as expectations among players in the economy and a relatively soft response in financial markets. Exchange rate developments are also subject to great uncertainty. It should therefore be underlined that monetary policy will always be formulated on the basis of a comprehensive assessment of the economic situation and outlook, which could turn out to be different from what is currently expected.

The króna has strengthened considerably in recent weeks. Towards the end of January its exchange rate was 7% higher than at the end of October. Many factors have conceivably contributed towards this strengthening, such as a good balance in foreign trade recently, portfolio investments by foreign parties in domestic financial markets and increased fishing quotas. Nonetheless, the main explanation probably lies in the proposed aluminium project. This will be accompanied by large-scale currency inflows over the next couple of years and increases in the policy interest rate. In a forward-looking market both these factors ought already to be strengthening the exchange rate, since the project is largely foreseen. On the other hand, the higher exchange rate prepares the economy for this investment by bringing down inflation and contributing towards more slack in the economy in the build-up to it. Market participants are conceivably overestimating the proximity and importance of these investments to some extent while underestimating the slack that has already formed, however, meaning that the strengthening of the króna would partly be based on unrealistic expectations. All the same, there are no grounds at present for claiming that either or both of these factors has played a major part in the recent currency appreciation. The Central Bank decided in January and February to take advantage of these conditions to step up its currency purchases in the interbank market, with the aim of improving its foreign position.

The Central Bank intends to notify credit institutions shortly of changes in rules on required reserves, as a step towards bringing the operating environment of Icelandic credit institutions into harmony with that of comparable institutions in most other European countries. The changes will be made in two phases. Phase one will involve some reduction in the required reserve ratio, and under phase two the Central Bank's rules on the required reserve base and ratio will be brought into line with rules set by the European Central Bank for credit institutions operating within EMU. It is planned to launch phase one in the next few weeks and the second phase no later than the end of this year. Both steps will presumably lead to a similar reduction in the overall required reserve.

The inflation forecast presented here gives grounds for a further reduction in the Central Bank policy rate, since inflation is under its target throughout the forecast period. The Central Bank has therefore decided to cut its interest rate on repo transactions with credit institutions by 0.5 percentage points as of February 18. After this reduction, the Bank's interest rate will be at its lowest level since 1994, when inflation was only 1½% and the negative output gap was far wider than now. In real terms the Central Bank's interest rate is after the change around 2¾%, which is some way below the current estimate of equilibrium interest rates and the lowest level since the spring of 1996, when the slack in the economy was greater than now. The planned reduction in required reserves will also imply some relaxation of the monetary stance. Whether and on what scale any further easing of the monetary stance is made will depend as before on developments and prospects. Different trends of uncertain strength are at work there and these will change in the course of time. Crucial factors are the uncertainty about the scale of slack in the economy in the first months of this year and how quickly the economy will pick up on account of the proposed power-intensive industrial project or other developments. Another important factor in this context is global economic developments, which are fairly uncertain at the moment.

The Central Bank does not consider that there is much risk of price deflation in Iceland, cf. the discussion of this point in the chapter on Economic and Monetary Developments and Prospects, and therefore no grounds to ease the monetary stance sharply for that reason. In the Bank's view, there is no justification either for a sharp cut in its interest rate with the sole aim of engineering a depreciation of the exchange rate of the króna. Part of the recent strengthening of the króna can probably be attributed to a rise in the equilibrium exchange rate. It is therefore almost certain that a considerably lower rate of interest than is compatible with the Central Bank's inflation target would be required to reverse recent exchange rate developments completely. That would pose a risk of kindling Iceland's next phase of economic overheating and instability. The Central Bank will therefore continue to decide its interest rates with reference to the inflation target, as it is obliged to do.