Introduction

Inflation outlook has worsened and the Central Bank raises its policy interest rate

Economic developments in recent months have been characterised by robust growth of domestic demand and accelerating inflation. Output and national expenditure growth were higher than the Central Bank had forecast in March. Indicators of developments in the first months of this year point to broadly the same rate of growth in private consumption as in 2003. Investment in housing has grown briskly and business investment other than in the aluminium industry and related power plants appears to be picking up. These developments suggest that the negative output gap will close sooner than was previously expected.

Inflation has been gaining momentum in the past few months and exceeded the target in May. Part of the increase in inflation is attributable to rises in oil and commodity prices in world markets, which monetary policy does not have to respond to. However, core inflation has also risen considerably and exceeded the target in May. A major contributing factor was ongoing increases in housing prices, which in the Greater Reykjavík Area reached their highest value in real terms, relative to the CPI, since measurements began. Housing prices are therefore probably overstretched. Increases in prices of goods and services in the CPI have also been gaining speed recently.

Credit growth at deposit money banks (DMBs) has been soaring in recent months. Total DMB lending and marketable securities showed a huge increase of 37% over the twelve months until the end of April. The sharpest growth is in lending to foreign borrowers and investments in domestic and foreign marketable securities. Foreign lending and securities investments entail a credit and market risk which has a bearing on evaluations of financial stability, but are neither a signal nor a driver of domestic demand. Domestic lending by DMBs has also surged in recent months, by almost 22% over the twelve months until the end of April. This is a higher rate of growth than is compatible with low inflation and macroeconomic stability in the long run. Nonetheless, there are indications that this is by and large a temporary surge connected with leveraged buyouts of Icelandic businesses. Another factor at work could be the Icelandic banking system's growing share in domestic corporate finance, in particular with loans denominated in foreign currencies. Thus the recent growth in domestic lending does not necessarily indicate higher levels of investment and other economic activity in Iceland. Lending by the credit system as a whole has grown less than DMB lending. Likewise, DMB credit growth ought to slow down following the leveraged buyouts, which in fact happened in April. Data on the composition of DMB lending support these interpretations to some extent, but exactly how tenable they are will depend on the way that developments unfold over the next few months.

This *Monetary Bulletin* includes the Central Bank's macroeconomic forecast until 2006 and its inflation forecast until the first half of that year. As usual, the forecast assumes an unchanged policy interest rate and unchanged exchange rate, which is just over 3% weaker than was assumed in the previous forecast in March. Fiscal policy assumptions are based on the budget for the current year, on planned expenditures in the government's medium-term scenario that accompanied the draft budget last autumn, and on recent Ministry of Finance estimates. The forecast incorporates tax cuts equivalent to a total of 2½% of GDP in equal steps over the period 2005-2007. While this policy measure is in line with the government's most recent medium-term scenario, considerable uncertainty surrounds its implementation. Other forecast assumptions have changed to reflect unfolding economic developments and the latest available data, as well as forecasts by international institutions where appropriate. The most important factor is the severe deterioration in the outlook for fuel prices, which has a negative effect on Iceland's terms of trade this year and upsets short-term inflation prospects.

Forecasts for the growth of national expenditure and GDP this year and in 2005 have been revised upwards. The output gap will turn positive sooner than was previously expected and, all things being equal, will be substantially positive in 2006. Hefty growth in national expenditure will spur imports of goods and services this year and next year, by 11-12% annually. In addition, the balance on income will worsen due to growing foreign debt and higher foreign interest rates. According to the forecast, the current account deficit will continue to widen and could reach the equivalent of 11-12% of GDP in both 2005 and 2006. If this forecast holds, Iceland's net external debt will deteriorate from a negative position equivalent to 67% of GDP last year to 85% in 2006. It appears that only roughly half of the forecast current account deficit can be attributed, directly and indirectly, to investments in the aluminium industry and associated power plants. Suitable policy measures should be able to prevent this forecast from being realised; one of the assumptions underlying the forecast is an unchanged monetary stance. A tighter monetary stance will dampen domestic demand, and other economic policies will need to follow suit. The endogenous dynamics of the exchange rate and asset prices will also counteract this development. However, the forecast calls for both tight and vigilant economic policies in the medium term. In particular, the fiscal stance will need to be tighter in 2005 and 2006 than is assumed in the forecast. The proposed tax cuts over these years will need to be matched by greater cuts in government spending than assumed in the forecast, to prevent Treasury finances from stimulating domestic demand. Should this not be done, monetary policy will be forced to bear the brunt of the tighter stance. This would pose a risk that the real exchange rate of the króna would be kept stronger than otherwise, squeezing the export and traded goods sectors. Such developments could lead to a more difficult adjustment when the current upswing ends than would otherwise be the case.

According to the forecast, inflation will remain above target over the entire horizon. The overshoot is greater in the near term than further ahead, due to higher fuel prices and the weakening of the króna since the March forecast. Inflation may even move above the 4% tolerance limit of the target in the next quarters. A number of developments could make this scenario less likely, such as a faster fall in fuel prices than assumed here, a fall in housing prices or an appreciation of the króna. All these factors are uncertain at present. Monetary policy can ignore the aspects of these developments that derive from oil price rises, but not the others. The Central Bank has therefore decided to raise its policy interest rate by 0.25 percentage points. The outlook presented here could warrant an even larger rise on this occasion. Thus the Bank can be expected to raise its policy rate again shortly if new data fail to give firm indications of improved inflation prospects.