Introduction

Outlook for interest rates broadly unchanged since November

In recent months the rate of inflation has been just below the Central Bank's target of 2½% and marginally lower than when the last *Monetary Bulletin* was published in November 2003. According to the updated inflation forecast published in this issue, inflation will remain below the target until the second half of 2005. Around that time it is expected to rise above the target, assuming that the exchange rate and Central Bank policy interest rate remain unchanged. In assessing price developments and the inflation outlook it is important to bear in mind that the current strength of the króna is probably unsustainable in the long run. Recent price developments and forecasts based on the assumption that the króna will remain strong may therefore underestimate latent inflationary pressures. Capital inflows over the next two years may bolster the króna, but this cannot be taken for granted given that conditions could change.

A sizeable increase in productivity last year appears to have contributed to the recent low rate of inflation, despite higher output growth in 2003 than forecast in November. If productivity continues to grow at an unusually brisk pace, it will ease inflationary pressures in the near term. The recently concluded wage settlements, which broadly speaking seem compatible with the inflation target, include provisions that could induce greater efficiency in business operations. Another recent factor that has served to ease inflationary pressures is that rapid growth in national expenditure has primarily been channelled into increased imports. It has therefore exerted less pressure on domestic factors of production than otherwise, but was reflected in a widening current account deficit equivalent to roughly 5½% of GDP last year. While the current account deficit is partly explained by the large-scale hydropower investments now under way and by weak exports, it is somewhat wider than previously forecast. In the long run, an excessive current account deficit could undermine the exchange rate and fuel inflation, although this does not appear to be much of a threat within the horizon of the forecast presented here.

The Central Bank's macroeconomic forecast presented here is not a comprehensive forecast reviewing all the relevant factors, but an update to the November forecast. Compared with November, the most important revision to the forecast is that the Norðurál aluminium smelter expansion is now assumed to go ahead, which raises projected output growth to 3½% in 2004 and 4½% in 2005. The appreciation of the króna, strong increase in productivity in 2003 and large share of foreign labour employed on the hydropower project will result in less pressure on domestic factors of production and prices than would otherwise be the case.

The Central Bank's policy interest rate has remained unchanged for more than a year. Its implicit monetary stance is probably close to neutral, and the policy rate is close to those in inflation-targeting countries where conditions are similar. In the November *Monetary Bulletin* it was stated that an interest rate rise was probably on the horizon even if the Norðurál expansion did not materialise, since according to the forecast published then inflation would rise above the target two years ahead, assuming that monetary policy remained unchanged. So far, however, the Central Bank has considered a rise in interest rates premature. While inflation was higher in Q4 than forecast in November, it abated in the first months of this year and was some way below the target in the beginning of March, at 1.8%. In addition, the króna began to strengthen towards the end of 2003. Indications of substantially increased productivity and the weaker-than-expected labour market last year gave further grounds for a cautious approach. Moreover, the budget was passed in parliament with a greater surplus than the draft budget had entailed, and no decision has yet been announced on the scope and form of proposed changes in housing loan arrangements.

The inflation forecast presented here does not indicate that inflation will rise above the target until the second half of next year. In this respect conditions are broadly the same as in November. However, three qualifications need to be made. Firstly, the updated forecast is based on an exchange rate that leaves the króna 5% stronger than in November. It is uncertain that the króna will remain so strong. Secondly, the hydropower and aluminium projects are now closer to the peak in their activity. Thirdly, there is an overwhelming probability that the Norðurál expansion will go ahead, as the updated forecast assumes. Although Norðurál affects the forecast less than might have been expected, since the stronger króna and unusually high productivity growth last year temporarily dampen inflation, its impact is nonetheless considerable. The uncertain macroeconomic impact of the pending projects also needs to be underlined. Historically they are unparalleled in terms of both their scope and the economic environment in which they are implemented, i.e. under free capital movements and a floating exchange rate.

In the Central Bank's view, financial stability is satisfactory but credit growth, the external debt position and asset prices are causes for concern. The Bank's analysis of financial stability presented in this issue now focuses more explicitly on the stability of markets. The legal and regulatory framework for the markets has been formulated over several years and is considered effective. Operational security is in rather good order but the main weaknesses of Icelandic markets are their limited liquidity and limited number of participants.

Macroeconomic conditions for financial stability are favourable on the whole and have changed little since the last report in November. The same applies to the position of households and businesses, despite a further increase in their debt. Financial companies have reported record profitability, and it largely derives from other factors than conventional banking activities. Provisions for loan losses were stepped up substantially last year. The position of major financial companies is relatively firm and they are acceptably resilient towards conceivable shocks. The main concerns are the expansion in largely foreign-financed lending, and high asset prices. Most of the growth in lending has been to corporate and foreign borrowers. Domestic lending has also grown briskly over the past year, at above a rate which is consistent with long-term price stability and a stable economy. Leveraged buyouts of listed and unlisted companies are one explanation behind this trend.

Following the Bank's financial stability report in November, the Board of Governors met chief executives of the commercial banks and largest saving bank and reiterated their concern about the rapid increase in lending and high levels of foreign short-term financing. The Board of Governors deemed it necessary to emphasise these views with a letter to the banks dated December 18, 2003, which was later made public. The public sector and the Central Bank have improved their foreign position, but the private sector position has worsened in recent years. Given this development, it is important that the commercial banks have spread their foreign funding better in the past couple of years and, more recently, have been lengthening the maturity of their borrowing.

Although price stability and financial stability are two distinct central bank objectives, they are related. Their interaction is currently under the spotlight in the international arena. To some extent this discussion relates to the monetary policy challenges that Iceland now faces. Housing prices in the Greater Reykjavík Area are high in historical terms and appear to have reached a peak, for the time being at least. Listed equity prices, including those of financial companies, have surged so far this year after record rises in 2003, prompting the question of what the impact will be should asset prices head back down. As discussed in previous issues of *Monetary Bulletin*, a sharp and sudden tightening of the monetary stance could conceivably send asset prices downwards. Thus it is important to avoid having to make too rough a monetary adjustment. Bearing this in mind, it is crucial to maintain a tight fiscal stance at the peak of the aluminium industry investments, and not to fuel credit expansion.

All things being equal, the updated inflation forecast presented here calls for a higher policy interest rate in the coming months, even though the price outlook is favourable until some time next year. Because monetary policy needs to be forward-looking, this could well mean that the Central Bank will raise its policy rate even though inflation is still below the target. Large-scale investments over the next few years mean that monetary decisions need to take into account a longer horizon than usual. Considerations of financial stability call for the same approach. Any decision on how soon the policy rate should be raised will need to weigh up which is the riskier option: interest rates that are temporarily lower than is necessary to ensure that the inflation target is attained, or higher. Given the scale of the pending investments and their impact on aggregate demand, slow rises in the policy rate over the next few months are unlikely to create an excessively tight monetary stance except perhaps for a very short time, and should not therefore result in much loss of production. This risk must be weighed against the potential threat of too lax an initial stance, which would demand a correspondingly harder adjustment later on, with all the consequences that would entail. The Central Bank will assess this challenge in the near future. It will also closely monitor what housing loan arrangements are decided, for example whether measures are taken to counteract the expansionary effect of raising the loan ceiling and maximum loan-to-value ratio. Another crucial consideration is whether the fiscal tightening announced for this year actually materialises, and on a longer horizon what fiscal stance is adopted in 2005 and 2006.