Introduction

The Board of Governors of the Central Bank of Iceland have decided to raise the Bank's policy interest rate by 0.5 percentage points on September 21. This is the fourth in a series of interest rate increases that the Bank considers necessary in response to soaring demand growth and to counter the impact that large-scale investments in the coming years will have on the economy and inflation outlook. In all, the Bank has raised its policy rate by 1.45 percentage points since May this year, and it will stand at 6.75% after the rise that has now been decided. This issue of *Monetary Bulletin* discusses how economic developments have unfolded and the circumstances underlying the Board of Governors' decision. It also includes an in-depth analysis of financial stability.

The economic outlook demands a tighter monetary stance

In *Monetary Bulletin* 2004/2, which was published at the beginning of June, the Central Bank presented its macroeconomic and inflation forecast which showed that inflation would accelerate, and move close to the upper tolerance limit of the inflation target, in the second half of this year and into 2005. The main forces driving inflation were identified as growing demand, the weakening of the króna and higher fuel prices. Since the forecast was published, developments have unfolded broadly in line with the assumptions on which it was based. As usual the forecast was based on technical assumptions of an unchanged policy interest rate and unchanged exchange rate over the forecasting period. In the period since the forecast was made, the króna has been on average just over 1% stronger than originally assumed. Changes in the exchange rate have therefore had little impact on the longer-term price outlook. The Central Bank has also raised its policy rate since the forecast was made.

Although inflation has approached the upper tolerance limit of the target earlier than was widely expected, the probability that it will exceed the limit as early as this year has also diminished. The crucial consideration is that the inflation outlook two years ahead appears to be broadly the same as it was at the beginning of June. However, there appears to be a risk of higher inflation in 2006 than was forecast in June, in light of the outlook for a rise in import prices which exceeds what was implied in the forecast. Domestic demand growth this year is also heading higher than in the macroeconomic forecast on which the inflation forecast was based. Demand growth over the next two years now appears more likely to exceed the June forecast. The impact of new price-indexed mortgage loans offered by the banks is still difficult to assess, but they are likely to stimulate demand.

One of the most intensive investment periods in Iceland's history lies ahead. The monetary stance will need to be very tight for its duration. It should also be taken into account that the impact of these investments will be felt beyond the horizon of the inflation forecast. Although the horizon of the Bank's forecast is roughly two years and monetary policy decisions are generally targeted at this timeframe, it must be taken into account that the risk of price instability may be at its highest towards the end of the investment phase, over the period 2006 to 2008. As usual, the price outlook is very much dependent on the króna remaining strong while investment activity is at its peak, thereby countering the inflationary impact of the widening output gap. Much also depends as to whether price assumptions on which wage settlements have been based hold good.

Seasonally adjusted unemployment has increased somewhat in recent months and employment decreased year-on-year in the first half of 2004. The extensive use of foreign labour for construction of the power station in east Iceland has also softened the project's impact on domestic wages. Nonetheless, it would be rash to infer that there is enough excess capacity in the labour market to preclude the risk of wage drift when the investments gain momentum and projects are launched closer to the Greater Reykjavík Area, the heart of the Icelandic labour market. Subsequent bottlenecks in the labour market could prompt wage drift in certain sectors which would extend to other parts of the labour force. Furthermore, new data show a sizeable increase in the number of vacancies, especially in and around Reykjavík.

Considerable uncertainty surrounds the macroeconomic impact of the investment projects, including their effect on the exchange rate, although their scale is broadly known. Monetary policy decisions need to take this uncertainty into account, along with the fact that monetary policy cannot be used to fine-tune demand in the economy at any given stage of the investments. As pointed out in previous editions of *Monetary Bulletin,* the Central Bank does not see much risk stemming from a temporarily tighter monetary stance than is directly warranted by price developments and demand growth. Too lax a stance for most of the investment period, on the other hand, could have serious consequences. If an excessive output gap at the start of the investment phase causes inflation to climb once construction activity enters full swing, an even tighter stance may be required later, leading to a hard landing and problems for the financial system.

After the Central Bank produced its last forecast in May, the policy interest rate was raised by 0.75 percentage points in all, i.e. 0.25 percentage points at the beginning of June and 0.5 percentage points a month later. The Bank had already raised the policy rate by 0.2 percentage points in May. The policy rate hikes can be seen as the Bank's first steps in its efforts to ensure that the investment projects, which will intensify over the next two years, do not undermine price stability. By raising its policy rate, the Bank also responded to higher-than-expected demand growth and accelerating inflation. Although inflation was partly of external origin, beyond the control of the Central Bank, rapid demand growth also clearly contributed to it.

To some extent the increase in the policy rate now can be regarded as a response to growing inflation expectations, which had reduced it in real terms since the hike in June, and other changes affecting financial conditions. Since the policy rate was again raised in July, developments in the housing market have brought about a considerable reduction in mortgage interest rates. As a result of these developments, the financial conditions of households are probably easier now than when the Central Bank began raising its policy rate. Nor is it absolutely certain that the financial conditions of financial companies or other businesses are significantly tighter. Developments in the financial markets have therefore counteracted the Central Bank's measures in recent months. The Central Bank has to respond to this development, given that construction work on power stations and aluminium smelters will surge over the next few months. In part, the current policy rate increase aims to counter the easing of financial conditions that has been brought about by developments in recent months. However, this increase is not the Central Bank's final step in its measures to tighten the monetary stance sufficiently to keep inflation as close as possible to target in the coming years. Further interest rate rises may therefore be expected in the months to come, unless economic developments diverge quite substantially from the path suggested by economic indicators.

Fiscal policy and public sector finances in general will play a crucial role over the next few years. A tighter fiscal stance can reduce the probability that a very tight monetary stance will be needed, which could squeeze the competitive position of businesses and cause problems for them. If fiscal policy imposes an excessive burden on monetary policy, in the worst-case scenario this could undermine financial stability.

The financial system is fairly resilient in the face of macroeconomic imbalances

Financial stability over the coming years will be largely determined by how successfully the economy can be guided through the pending wave of large-scale investments. It is important to prevent the economy from overheating, with an accompanying upturn in inflation. Insofar as the economy is now entering this massive investment phase with rather higher inflation, a wider current account deficit and a more positive output gap than was assumed in the last financial stability report in March, the risks have increased somewhat.

Besides the intensifying investment projects, two factors warrant particular consideration. One is rapid lending growth and the growing indebtedness of both households and businesses, and the other is high asset prices. The risk accompanying this development is discussed in the financial stability report in this issue of *Monetary Bulletin*. International experience shows that, in combination, these two factors can pose risks to financial stability. Lending growth, largely funded from abroad, is still far more rapid than is compatible with stability in the long run. Although both household and business balance sheets have become more exposed to volatility in asset prices and exchange rates in recent years, their position seems strong at present. The planned extension of financing for homebuyers by the public Housing Financing Fund could raise household debt, and so could the commercial banks' and savings banks' recent offers of long-term mortgage loans at lower interest rates. Among businesses, debt continues to climb – part of it now driven by leveraged buyouts – but strong EBITDA boosts their resilience. The main concerns involve households' and businesses' ability to withstand major economic shocks, although these are unlikely over the next few years.

The position of financial companies was considered fairly solid in the last report made in March, and that assessment remains unchanged. Profitability of commercial banks and savings banks was on the whole robust in the first six months of this year and their capital ratios were relatively strong. Favourable price developments in domestic securities markets and position-taking are the main drivers of their profitability. Expansion abroad has broadened the banks' revenue base, but the bulk of their profits is still domestic in origin. Icelandic commercial banks have been determinedly expanding abroad in recent years. Internationalisation of banking has resulted in a raft of changes in the Central Bank's work and closer cooperation with participants in Iceland and abroad, although much clearly remains to be done in this respect. The Icelandic financial system has expanded its horizons and is becoming increasingly international in character and more dynamic.

The banks' large-scale foreign financing has been noted by domestic and international analysts of the Icelandic financial system. The Central Bank has urged the banks to pay careful attention to their funding and credit ratings. An important point was reached when the banks began lengthening the maturities of their foreign-denominated funding late last year, and for more than a year now their short-term borrowing has not increased. It is also reassuring to note that the banks' credit ratings have been upgraded over the past two years. In collaboration with the Financial Supervisory Authority (FME), the Central Bank held talks this summer with experts from the largest commercial banks on foreign currency liquidity management. An agreement was reached on the principles that contribute to sound practices for foreign currency liquidity management, and the FME will presumably issue guidelines to this effect.

In domestic securities markets, a number of changes have been made in trading and settlement implementation, and the efficiency of the markets has been put to the test over the past six months. Broadly speaking, the markets can be said to have passed that test. The same applies to payment system operations. Through the reforms made to the Icelandic payment systems in recent years, the Bank considers that significant progress has been made in limiting legal, default, liquidity and settlement risks. As far as the next steps are concerned, the Central Bank identifies both the opportunity and the need for careful consideration of operational risk in payment systems.

Financial stability has two aspects. One is the risks that the financial system faces, and the other is its resilience. Risk is always present, although it can be contained to a certain degree. Insofar as risk cannot be avoided, tasks for promoting financial stability must focus on strengthening the resilience of the system, i.e. promoting an efficient and safe financial system, as the Central Bank of Iceland Act says. It was foreseeable that macroeconomic imbalances would increase alongside the large-scale investments for the aluminium industry that have now been launched and will continue over the next few years. The risks posed to the financial system have grown accordingly. It is gratifying to note that the resilience of financial companies and markets has been increased at the same time and can be considered fairly strong at present.