

Introduction

Better macroeconomic balance and decreasing inflation create conditions for a further easing of the monetary stance

The imbalances that prevailed in Iceland's economy during the latter half of the upswing have largely disappeared. Pressure in the goods and labour markets has eased, the current account balance has moved well within sustainable limits and inflation is rapidly on the decrease. The Central Bank's inflation target could be attained before the end of the year. The fundamentals for economic stability have therefore been restored. This creates conditions for an acceptable rate of economic growth at the same time as inflation remains close to the Central Bank's target.

The tight monetary stance of recent times has played the greatest part in the success that has been achieved. High interest rates reduced investment and private consumption, and bolstered the exchange rate of the króna after pessimism gave way to confidence, when the unions and employers agreed to postpone their review of wage agreements until this May and tie it to a specific price level target. Lower demand in the goods and labour markets and a stronger exchange rate then dampened inflation from both domestic and foreign sources.

These changes in the macroeconomic situation call for a new orientation of economic policy. Monetary policy must ensure that the inflation target is attained, but as this comes closer to being realised, conditions are created for addressing to some degree the low economic growth rate and slack in the goods and labour markets. How big this slack will turn out to be is still highly uncertain. While there are signs that demand for goods and services has bottomed out, it cannot be stated absolutely that a measurable upswing has begun. Considerable uncertainty also

pertains as to whether there will be a surge in corporate investment if no power-intensive industrial investment materialises. Most of the signs suggest that the slack in the labour market will intensify for the time being, however, since historical and international experience show that it lags behind the general demand cycle.

The twelve-month rise in the CPI in June moved within the upper tolerance limit of the Central Bank's inflation target for this year. This was in line with the Bank's inflation forecast, which was fully realised in the second quarter. On a shorter-term view, the underlying rate of inflation is probably already consistent with the Bank's inflation target. At present it is primarily domestic in origin. Inflation expectations in the bond market are also in line with the Bank's target.

The inflation outlook has improved since the Central Bank published its last inflation forecast, mainly due to the strengthening of the króna. Assuming an unchanged exchange rate and monetary stance, twelve-month inflation is now forecast to move within the long-range tolerance limit of the inflation target as early as the third quarter, and the Bank's inflation target will be attained before the end of the year. Projected two years ahead, inflation will fall below the Bank's target.

In recent weeks the exchange rate of the króna has been relatively stable and somewhat higher than in the spring. For some time now the Central Bank has identified a need to strengthen its foreign position. Hitherto, however, it has not purchased foreign currency in the market to this end, since the inflation

target has enjoyed absolute priority and the Bank has not wanted to jeopardise the exchange rate. The Bank now considers that conditions are in place for moderate currency purchases of this kind and will publicly announce its intentions in that regard in the near future. It should be underlined that the aim of currency purchases will be to boost the Bank's foreign position, not to seek to maintain the exchange rate of the króna within specific limits.

The inflation forecast and analysis of the economic situation and outlook presented here demonstrate that the fundamentals are in place for a further reduction in the Central Bank's policy interest rate. The Central Bank interest rate is now around 5½% in real terms and in fact higher based on a one-year inflation projection. This is above the equilibrium real interest rate and too high with respect to mount-

ing slack in the economy. The Bank has therefore decided to cut its interest rate in repo transactions by 0.6 percentage points. It will be reduced even further in the months to come if subsequent events confirm that the inflation target will be attained and demand develops along the lines currently foreseen. If demand grows faster than is thought likely at the moment, however, the situation could naturally change. Later, power-intensive industrial development could also fuel pressure in the goods and labour markets, thereby calling for a timely response on the part of the Central Bank. As argued in the following article in this edition of *Monetary Bulletin*, however, the time has still not come for taking specific account of these factors in the Central Bank's interest rate decisions.