Introduction

Tight monetary policy will be maintained for longer than was expected

Imbalances in the economy have increased since *Monetary Bulletin* was last published on June 3 and are currently larger than for a very long time. Macroeconomic conditions are in many respects comparable with those prevailing in 1999 and 2000. The upswing then was followed by a sharp readjustment in 2001 and 2002. The imbalances are even more pronounced now: the current account is wider, housing prices are further above long-term equilibrium, and gross debt of households, businesses and the economy as a whole is substantially greater. In other ways the situation is different, however. Soaring private consumption over the past two years has been driven more by mounting household debt than by disposable income growth, which was considerably faster in 1998-2000. Higher labour costs exert less inflationary pressures now, but house price inflation has more impact. External conditions are also quite different. In 1999 and 2000, the Central Bank's tighter stance coincided with restrictive policies in most trading partner countries; now, unusually low interest rates in Europe and elsewhere are a major driver of domestic credit expansion. They have extended the lag in transmission of monetary policy and diverted much of it towards the exchange rate channel. The challenges currently faced may even be tougher than in the previous upswing. On the other hand, the fundamental change in the monetary policy framework since then gives monetary policy greater scope for tackling inflation.

In the medium term, economic conditions in Iceland will be unusually challenging from a monetary policy point of view. How successfully monetary policy can be applied to prevent inflation from becoming anchored above the target will be a test of how suitable the current framework is for a small open economy. In the Central Bank's view it is vital for monetary policy to pass this test and not allow inflation to deviate substantially from the target except very temporarily. Otherwise there is a risk of damage that the credibility of the Central Bank and its monetary policy could be eroded and prove difficult to regain.

Thus it is disappointing that, in spite of sharp rises in the policy interest rate since May last year, the inflation outlook two years ahead is still unsatisfactory, especially when the inflation risk posed by a possible depreciation of the króna is taken into account as well. One year ahead, the inflation outlook has actually worsened since earlier this year, even though the strong króna has kept increases in goods prices in check. A combination of factors is at work: Rapid house price inflation which is built in to the CPI for the coming months, soaring domestic demand, a wider output gap and higher-than-expected rises in unit labour costs. These factors outweigh the strength of the króna.

The pace of domestic demand growth has repeatedly come as a surprise. Private consumption growth has been particularly rapid over the past three quarters. In the second quarter of this year, the twelve-month growth rate of private consumption was 14%, the fastest in the history of the quarterly national accounts. In the same quarter, the current account deficit was equivalent to 14% of GDP. There is no sign of any significant let-up in private consumption growth in Q3, or that the current account deficit is narrowing. On the contrary, it can be expected to widen even further in the second half of the year. Although a sizeable share of the current account deficit is explained by investments in the aluminium and power sectors, which will boost export revenues in the long run, the remainder is still equivalent to as much as 7% of GDP this year. Thus it must be considered unlikely that there is less need for an adjustment now than in the wake of the episode of overheating from 1999 to 2000.

This is not to say that the adjustment will follow the same pattern, however. Apart from unforeseeable changes in external conditions, which could have a considerable effect on the speed at which it takes place, the adjustment will be shaped by the fact that the monetary framework has changed since then. Compared with 1999 and 2000, the monetary stance has been tightened faster and the floating króna has appreciated by more. This has constrained inflation and inflation expectations, as well as businesses' capacity for raising wages and passing on the higher cost to prices. It has also made foreign borrowing less favourable, after taking the currency risk into account. Inflation and inflation expectations would be even higher if monetary policy were still shackled by the fixed exchange-rate regime, and in the current labour market climate they would have been driven by wage rises. Such a spiral ultimately hampers the competitive position of businesses, undermines the exchange rate policy and, in the worst-case scenario, ends with a currency crisis.

A risk of this kind is far more remote now. Nonetheless, it cannot be ruled at that, over some period, the exchange-rate adjustment will be faster than is compatible with the inflation target. The Central Bank might need to respond to such a development by raising the policy rate. It is difficult to foresee how high the policy rate would need to be during the adjustment phase. In their forecasts, certain market analysts appear to assume that the Central Bank will not act even if the exchange rate develops at odds with the inflation target. Such an approach would not be consistent with the Central Bank's mandatory duties.

Important lessons can be learned from the implementation of monetary policy in the last upswing. Two main points stand out. First, it is obvious that the fixed exchange-rate framework left the monetary stance too lax at the peak of the upswing.[1] Second, the need for the exchange rate to adjust after the króna was floated was underestimated for a long time, which also resulted in an insufficiently restrictive monetary policy. Part of the explanation is that the Central

1. However, the scale of the overheating in 2000 was admittedly not fully known until some way into 2001.

Bank had already used its foreign reserves quite sharply in an effort to defend the króna before the fixed exchange-rate regime was abandoned in March 2001.

The adjustment is likely to begin at an earlier stage this time around, be softer and give the Central Bank more room for manoeuvre to ensure that the inflation target is attained. In the last upswing the policy rate peaked at 11.4%, and just over 7% in real terms. The current monetary stance still falls some way short of being as restrictive as then. Similarly, the economy will clearly overheat even more this year than it did the last time. This deserves to be borne firmly in mind, because in retrospect the monetary stance in 1999 to 2001 does not appear to have been sufficiently tight.

Had inflation expectations kept in line with the target, a comparably tight stance could conceivably have been achieved at a lower policy rate level. However, this has not been the case. Inflation expectations seem to have become anchored above the target, and even long-term expectations as well. Analysts and other influential parties appear to assume that the Central Bank will allow inflation to rise far beyond the target and stay there without taking any action. As a result, the Central Bank could be compelled to make an unexpectedly large hike in the policy rate in order to bring inflation expectations back down towards the target. Also, a tight stance probably needs to be maintained for longer than has been expected. Market expectations about the policy rate soon peaking and then beginning to fall again are unrealistic and delay the transmission of monetary policy across the interest rate curve.

In September, inflation exceeded the target by more than 1½% for the second time this year. The report to the Government which was published on September 19 in connection with the overshoot is printed in this edition of *Monetary Bulletin*. According to the baseline forecast presented here, the inflation target will not be attained until 2008 if the policy rate is not raised further. This is an unacceptably long time, especially considering that the exchange rate is also forecast to remain very strong. The Central Bank will therefore continue to work resolutely towards bringing inflation back to target within the forecast horizon. It has sufficiently powerful instruments to achieve that task, even though turbulence in foreign exchange markets might temporarily send inflation off course. Another forecast, based on market expectations about the interest-rate path and a variable exchange rate, underlines the uncertainty connected with exchange rate developments.

Nonetheless, inflation forecasts are merely analytical tools – not absolute truths. Uncertainties about the probable long-term adjustment of the exchange rate, asset prices, the external balance and foreign interest rates imply that the forecast two years ahead may give a misleading picture of how developments will unfold. That said, recent economic indicators and the economic outlook indicate an unquestionable need to tighten the monetary stance further. The Central Bank has therefore decided to raise its policy interest rate by 0.75 percentage points. By taking such a large step on this occasion, the Central Bank will hopefully succeed in convincing households, businesses and the financial markets that it is absolutely serious in keeping inflation as close as possible to the target over the next two years and further ahead, even if this temporarily hits certain sectors hard. Leaving inflation to its own devices and allowing it to take root would be even more costly, since the process of unwinding such a development would require more painful measures. The side-effects of the tight monetary policy can be softened by constraint on the part of the private and public sectors, and last but not least with cautious lending policies by credit institutions.