Introduction

Results of tighter policy stance begin to appear, which must be followed through

The 0.75 percentage-point increase in the Central Bank's policy interest rate in September marked a turning point in the transmission of monetary policy across the yield curve. The nominal change delivered an equivalent change in real terms and – for the first time since the Central Bank began raising the policy rate in May 2004 – indexed bond yields were affected significantly, which has already led to higher mortgage rates by the banks and Housing Financing Fund. Given that the bulk of household debt is price-indexed, the transmission of the policy rate hike to indexed lending is essential. Last year's fall in indexed rates and subsequent surge in credit supply unleashed soaring credit demand for the purpose of refinancing housing purchases and private consumption. The resulting house price inflation further fuelled private consumption and residential investment. If mortgage rates continue to rise, house price inflation will slow down further and, eventually, so will private consumption growth.

Should domestic demand growth slow down sufficiently, it will facilitate the attainment of the target of inflation close to 2½% over the medium term, as obliged by law and under the joint declaration of the Government of Iceland and Central Bank of Iceland from 2001. The response to the September policy rate hike is promising, but to claim victory in the battle against inflation is premature. Strong imbalances are still present in the economy. The macroeconomic forecast presented in this edition of *Monetary Bulletin* indicates sizeable capacity pressures over the next two years. Hence, other things being equal, inflation will remain some way above the target in the coming months, notwithstanding the effect of the strong króna, although the outlook is somewhat better than in September. Inflation scenarios based on the assumption of an unchanged exchange rate must be viewed with caution, however, because it is unlikely that the króna will maintain its current strength across the forecast horizon.

The outlook is for an even wider current account deficit this year than was forecast in September. According to the updated macroeconomic forecast it will be equivalent to 15½% of GDP. A current account deficit on such a scale is rarely sustainable for long. International experience shows that such an imbalance is soon followed by a currency depreciation or a contraction in domestic demand, or both, which will force a readjustment. The more that the deficit is explained by investment in export sectors, the less adjustment is needed. However, less than half of the current account deficit this year and in 2006 can be attributed to the direct and indirect impact of investment in the aluminium and power sectors. Thus there will be a strong need for adjustment in the coming years, which will probably take the form of pressure on the króna. The high real exchange rate increases the likelihood that a substantial part of the adjustment will take the form of a depreciation. Currently, the real exchange rate is at its highest level since 1988, and in recent decades such episodes have only proved short-lived.

Monetary policy over the medium term will need to ensure that the exchange rate adjustment which appears inevitable in the long run does not result in a higher rate of inflation than is compatible with the target. A tight monetary stance will be required to do so, for as long as capacity and labour market pressures pose inflationary threats. Furthermore, a sufficiently wide interest-rate differential with abroad must be maintained to contribute to a smooth exchange rate adjustment.

Over the next few months, the twelve-month rise in house prices will probably slow down quite sharply. If the króna remains relatively strong and stable, goods prices are also quite likely to fall. Thus the outlook is for a slowdown in the inflation rate in the coming months. If the housing market cools more quickly than the Central Bank forecasts, house price inflation is likely to slow down even more sharply than is currently expected. Foreseeable exchange rate developments, an ongoing surge in private consumption and greater-than-expected rises in unit labour costs, however, will outweigh these factors in the long run.

Inflation scenarios based on different assumptions for interest rate and exchange developments provide an indication of what may lie ahead. Taken together, they strongly suggest that the inflation target will only be attained if a tight monetary stance is maintained for an extended period.

The Central Bank has repeatedly cautioned against ideas that the inevitable difficulties accompanying a tight monetary policy can be avoided by abandoning the inflation target temporarily, or "letting inflation through", as it has sometimes been called. This is an unrealistic option. Such a volte-face in Central Bank policy would immediately push up inflation expectations, fuel even higher wage increases and catalyse a depreciation of the króna and more inflation. Ultimately the policy rate would need to be raised by even more to bring inflation back down. Businesses and households would suffer more rather than less from such a policy. Nor should it be forgotten that a large share of household and business debt is either price-indexed or exchange rate-linked. Due to this distinctive feature of the Icelandic financial system, even the short-term benefits to households and business from a more accommodative monetary stance could prove to be minimal or even negative.

However, a tight fiscal policy can contribute to a softer landing. Buoyant demand and soaring business profits have generated revenues for the Treasury this year far in excess of forecasts. A similar position could be on the cards in 2006. It is vital for both central and local government authorities to respond to this boost in revenues not by easing their restraint on the expenditure side, but rather by planning to achieve increased surpluses, which appears to be the aim behind the budget currently before Parliament.

Financial companies can also contribute through cautious lending policies. Some have already lowered the loan-to-value ratios of their mortgage lending to 80%, which is a prudent decision both from an economic policy viewpoint and in light of their own interests.

Inflation has slowed down in recent months and the impact of policy rate rises is finally being transmitted to indexed bond yields, and thereby to some extent to mortgage interest rates. At the same time, the impact of higher interest rates in the US and Europe is increasingly being felt. Nonetheless, the inflation outlook is still unacceptable. The Board of Governors has therefore decided to raise the Central Bank's policy interest rate by 0.25 percentage points. Two months ago the Central Bank raised its policy rate by 0.75 percentage points. Next month the Board of Governors will reassess the situation and announce its decision on interest rates – irrespective of whether they will be changed or left unchanged – together with the rationale behind the decision, on the first formal interest rate decision date of the year, January 26, 2006. At the present stage it is difficult to determine what policy rate level is necessary in order to attain the inflation target.