

Introduction

Improved inflation outlook but a tight stance is still needed

The inflation outlook has improved substantially since the Central Bank published its last forecast in *Monetary Bulletin* in July. In Q3/2006, inflation was lower than had been forecast then and the long-term prospects are also more favourable. Nonetheless, they are still unacceptable and call for a cautious, tight policy. Expectations of a swift reduction in the policy interest rate in the near future are therefore unrealistic.

Disinflation over the past two months is partly the result of the sustained tight monetary stance that has led to a substantial rise in short-term real interest rates, a wider interest rate differential with abroad and an appreciation of the króna. However, a slowdown in inflation for two months is by no means solid evidence that the battle is over. Temporary factors, e.g. base effects, the appreciation of the króna and falling energy prices, are a volatile measure and can reverse. The risk of wage drift is not over yet. A tight monetary stance therefore remains unavoidable for the time being in order to ensure that inflation will continue to decrease and the inflation target will be attained.

While the positive signs are welcome, difficult challenges remain. Iceland has an enormous current account deficit, equivalent to more than one-fifth of GDP in 2006. Although credit growth has slowed down it is still substantial, the labour market is overstretched, sentiment is strong and restraint on public sector expenditures has weakened.

There is no sure-fire method for predicting exchange rate movements from their relationship with the current account deficit. Iceland is clearly dependent on the willingness of global investors and creditors to finance its deficit. Accordingly, the economy is more exposed to shifts in global financial markets and their responses to news, correct or otherwise, about its performance. Events in the first months of this year should still be fresh in people's minds.

The external balance has deteriorated further since the Central Bank's forecast in July. Certainly the current account deficit will narrow in the years to come, but in order to bring it to a sustainable balance over the next two years a tighter monetary stance is needed in the period ahead than the market currently appears to expect.

The factors pointed out above could lead to setbacks in the battle with inflation over the next few years. There are indications that demand, especially investment, in 2006 may turn out above forecast, so that the output gap and inflationary pressures may be underestimated. Excess demand for labour may be further evidence that this is the case.

Although business investment will shrink when investments in the power and aluminium sectors come to an end, it will take some while to achieve the necessary easing of pressures that appear in the form of labour shortages, the current account deficit and a wage-price spiral. A robust monetary stance must be maintained until internal and external imbalances have been reduced sufficiently to allow the policy rate to be lowered again without jeopardising the inflation target.

A tighter fiscal stance could expedite such developments. Certainly Treasury finances are impressive at the moment and much stronger than was previously estimated, in particular due to cyclical revenues generated by the economic upswing. However, this does not relieve the government of its duty to do everything in its power to ease macroeconomic imbalances. While the Central Bank does not pass judgement on legislative decisions concerning tax cuts as such, their timing is crucial for the effectiveness of monetary policy. Recently the government announced measures aimed at boosting household real disposable income, which at the same time will ease the stance and delay the necessary macroeconomic adjustment. These actions will not bring down underlying inflation even if measured inflation is temporarily reduced. Easier terms for lending by the Housing Financing Fund, which have also been discussed, would also serve to strengthen demand.

For all these reasons, a reduction in the policy interest rate is still not in sight, in spite of the substantial improvement in inflation prospects. On the contrary, it is impossible to rule out a further policy rate hike in order to attain the inflation target within an acceptable timeframe and the analysis presented here implies that there are still grounds for tightening the monetary stance further by raising the policy rate. However, the Board of Governors of the Central Bank of Iceland has decided to postpone such a measure for the time being, given the already very high policy rate, quite tight monetary stance and considerably more favourable inflation outlook than was forecast in the middle of this year. Because of prevailing uncertainty and the long interval before the first issue of *Monetary Bulletin* in 2007 is published, the Board of Governors has decided to add an interest rate decision date this year. The next interest rate decision will be announced on December 21, 2006. The decision made then will be based on the analysis in the current *Monetary Bulletin* and additional data that become available by that time.