

## *Introduction*

# Overheating calls for restrictive economic policies

Economic developments during the current year have confirmed the main message of the Central Bank's Autumn Statement published in November 1998. Then, the Bank warned that economic growth on the scale that had been maintained for some time was not compatible with low inflation in the long term, since production capacity in the economy was already fully utilized. It was also unlikely that import price and exchange rate developments would contribute to lower inflation in 1999, as had happened in 1998. In the Bank's opinion the most pressing task of economic policy was to contain the rapid growth in domestic demand and control excessive growth in lending. In this respect the Bank considered it vital to reduce the current account deficit by boosting national saving, in particular by improving the financial balance of central and municipal government. At the same time, the Bank expressed serious concern about the impact that the excessive growth in lending, financed with a high share of short-term foreign capital, could conceivably have for financial stability, as well as on domestic demand growth.

Signs of overheating in the economy are in fact much clearer now than a year ago and price stability has been disrupted. The labour market shows signs of excess demand and housing prices have risen considerably. Credit expanded at an even faster pace during the last months of 1998 and at the beginning of 1999 than in autumn 1998. The current account is heading for a deficit this year, which does not seem to be lower than in 1998, and is less linked to power-intensive industrial investment. Annual inflation to the beginning of November measured 5%.

Part of the increase in inflation can be explained by external or temporary factors, such as the large rise in petrol prices in international markets. The increase in the housing component of the CPI, which has also played a large role in inflation this year, is partly of the same nature. Housing prices have been rising after a low lasting many years. Furthermore,

the housing component of the CPI measures only housing prices in the Greater Reykjavík Area, which have recently risen by far more than elsewhere in Iceland. However, the large rise in housing prices is not least attributable to a large-scale general increase in incomes, credit expansion and easier public access to credit through the state mortgage system, in which respect it forms part of the general boom in demand which has been kindling inflation of late. Even if the higher petrol and housing prices are excluded, inflation has been on the increase. It would have measured around 3% in November if petrol and housing had risen by the same magnitude as other prices, and, all things being equal, the Central Bank forecasts 4% inflation next year. The main task of economic policies in the near future must therefore be to promote a lower rate of inflation once again.

The national budget and fiscal budget for the year 2000 assume a relatively moderate increase in domestic demand next year, and that economic growth will fall below 3%. Economic growth in the following years is expected to be even slower. If these forecasts hold good, the overheating that is now a characteristic feature of the Icelandic economy will subside. However, there are many indications that demand growth during 1999 is underestimated in the national budget and that next year's economic growth could exceed its forecast. In all probability the current account deficit will therefore be larger than assumed there. Thus it is a cause for serious concern that the national budget already forecasts, all things being equal, a current account deficit equivalent to 3% of GDP in the years to come. This bears witness to an underlying deficit which will not disappear when construction programmes for power-intensive development projects are completed. Another cause for concern is that efforts to increase national saving have still not produced results. There is every reason to take this problem seriously since in the long term the current account deficit can undermine exchange

rate stability, besides which the accompanying growth in external debt leaves the economy more susceptible to shocks.

The excessive increase in lending in the recent term presents a twofold problem. Firstly, it stimulates demand and kindles economic overheating. Secondly, it poses a risk to the stability of the financial system as a whole, in particular since the growth in lending has to a considerable extent been financed with short-term foreign borrowing. Two risks are involved here: That the large increase in lending during the upswing will increase the probability of substantial loan losses when a downswing occurs, and also that problems will arise in refinancing the foreign loans. The Central Bank has responded with three separate types of action. Firstly, it has raised its own policy rates, which has prompted an increase in lending rates within the banking system. Secondly, it has issued strong warnings to credit institutions and to the government as the owner of some of them. Thirdly, early this year the Bank imposed a liquidity requirement on credit institutions, aimed among other things at reducing the use of short-term foreign capital for relending. The result has been that lending is funded on a more secure basis than before, and its growth has also slowed down, although it is still faster than is compatible with stability and low inflation in the long term. The Central Bank will therefore continue to target its action against excessive credit growth.

Economic policies now need to tackle the twin problem of a current account deficit and too high inflation. Monetary policy can only target one of these two factors, and price stability is the natural target. Fiscal policy must be employed to counteract the current account deficit. Given that demand appears to be expanding more than was assumed in the national budget, next year's budget surplus will have to be correspondingly larger than the draft budget envisaged. Municipal government deficits at the peak of an economic upswing are another problem which needs to be addressed, since this weakens the restraint that fiscal policy exerts upon domestic demand. If municipalities fail to achieve a satisfactory result in this respect, the treasury surplus will need to be correspondingly greater.

The Central Bank has raised interest rates three times this year by a total of 1 ½ percentage points in order to strengthen the exchange rate and reduce inflationary pressure. The result has been that the inter-

est rate margin vis-à-vis abroad is now at its highest level since restrictions on short-term capital movements were abolished at the beginning of 1995. In recent months this has led to a strengthening of the króna, which early in November reached its highest rate since the devaluation of June 1993.

Monetary policy will continue to be restrictive. The Central Bank will keep short-term interest rates sufficiently high to encourage a rise in the króna relative to its exchange rate on October 25 when the Bank forecast an unacceptably high rate of inflation for next year. It is conceivable that Central Bank interest rates need to be raised even further in order to ensure that the exchange rate and domestic interest rates are sufficiently high to reduce demand and lending growth. In this respect, recent interest rate rises abroad also need to be taken into account.

The stable exchange rate policy which has been pursued in recent years has produced good results by promoting low inflation and stable economic conditions for businesses. New conditions, however, conceivably justify a reassessment of the exchange rate policy. The disinflationary phase which took place in the first half of this decade, and in which the stable exchange rate policy played an important part, is over. In the strong upswing now taking place, it would be preferable to be able to deploy the exchange rate in order to contain inflation. Capital movements are now by and large unrestricted and international experience shows that it can be difficult for a small country to maintain a virtually stable exchange rate under such circumstances. Finally, it should be mentioned that the launch of the euro could give grounds for reviewing Iceland's currency framework, especially if important trading partners, such as Denmark, Britain and Sweden, join the EMU. Any changes made to the currency framework would not alter the fact that price stability is the main objective of monetary policy. On the contrary, they would serve to strengthen and clarify this main objective.

This publication is the first in a new quarterly series from the Central Bank of Iceland. Together with the Central Bank Statistics which are now published on its website, this new publication replaces the Bank's Economic Statistics Quarterly. It also replaces the Central Bank's Autumn Statement which has generally been published in October or November each year.