Introduction

Reducing inflation is the main objective of monetary policy

Inflation in June exceeded the upper tolerance limit of the inflation target of the Central Bank of Iceland. According to the joint declaration by the government and Central Bank on inflation targeting and changes to the exchange rate policy, issued on March 27 this year, the Bank shall submit a report to the government if inflation moves outside the tolerance limits. The Bank accordingly submitted a report to the government on June 20 which is published in full in this issue of Monetary Bulletin. Its main finding on inflation prospects was that a precondition for bringing inflation down to 2½% in the year 2003 is to prevent a price, wage and exchange rate spiral. In the Bank's opinion, monthly increases in the CPI had probably peaked in June, but the twelve-month rate would continue to increase, at least until the autumn. The rise in the July CPI was consistent with this assessment. Furthermore, assuming an unchanged exchange rate and monetary policy, the Bank considered that inflation could remain above the tolerance limit until the beginning of 2003. The upper limit will be reduced from 6% this year to 4½% next year, then set at 4% from 2003.

The Central Bank publishes a new inflation forecast in this edition of Monetary Bulletin. The Bank now forecasts higher inflation than it did in May, because of the currency depreciation in May and the first half of June and large price rises in recent months. Now, the Bank forecasts inflation of almost 6½% between the years 2000 and 2001, and 8% from the beginning to the end of this year. This assumes that the exchange rate will remain unchanged from July 20. To a large extent, subsequent developments will be determined by three factors, i.e. exchange rate trends, whether there will be an upward review of wage agreements early next year, and how quickly demand growth will slow in the next few months. If wages do not rise next year in excess of already negotiated increases, the Bank is of the view that inflation could decelerate rapidly in 2002, even if the nominal exchange rate of the króna does not strengthen to any marked extent from its current position. Inflation could then run at 3% from the beginning to the end of the year and would return to within the tolerance limits towards the middle of the year. The 2½% target inflation rate would then be reached around the middle of 2003. Inflation prospects have therefore improved somewhat since mid-June, as also reflected in the inflation premium on treasury bonds.

The forecast is subject to considerable uncertainty as always. The very low real exchange rate – at its lowest level in June for the past two decades – might suggest that the nominal exchange rate could strengthen alongside a reduction in inflation expectations. This would lead to a lower rate of inflation. However, inflation will be higher if the positive output gap closes more slowly than assumed here, all other things being equal. The most important uncertainty involves wage developments and a conceivable review of wage agreements next year. As stated in the Bank's June report to the government, wages have risen far in excess of productivity increases and an acceptable rate of inflation in recent years, partly as the result of strong demand for labour caused by prevailing overheating of the economy. This growth in wage costs has played a considerable part in the depreciation of the króna and rising inflation in the recent term. Real wages have increased substantially in recent years, and last year the ratio of wages to national income was almost as high as when the economy overheated in 1987 and 1988. Thus the Central Bank does not consider that the fundamentals are in place for wage increases next year over and above those already allowed for in wage agreements.

Large fluctuations took place in the foreign exchange market in May and June. The exchange rate depreciated by a total of 7.9% from the beginning of May to a low on June 20. The following day the Central Bank sold foreign currency to bolster the króna and on June 22 the Ministry of Finance announced plans to borrow 25 b.kr. abroad in the name of the treasury in order to boost the Central Bank's external position. A Central Bank decision to pay a commission for market making in the interbank market for foreign exchange from July 1 to the end of the year was announced the same day. These actions, coupled with the abnormally weak exchange rate at the time, undoubtedly contributed to its rallying by 4.6% from June 20 to July 20.

In the Bank's view, the main explanation for the sharp recent depreciation of the króna exchange rate is the big imbalances that have prevailed in the Icelandic economy, and not the changes made to the monetary framework towards the end of March nor the interbank foreign exchange market structure. However, the foreign exchange market regime may have amplified swings under the circumstances that prevailed in the spring, as described in more detail in the articles on Market Developments and on the Structure of the Interbank Foreign Exchange Market. Possible further enhancements to the rules and framework governing this market will be considered.

The depreciation, higher inflation rate and inflation expectations which are considerably above the Bank's target greatly limit its scope for engineering a softer landing by cutting interest rates. In its June report to the government, the Central Bank pointed out that higher inflation expectations had brought down its real interest rates considerably from the position shortly after interest rates were cut at the end of March. Combined with the impaired outlook for the Bank achieving its inflation target in the near future, a rise in nominal interest rates could even have been justified. Nonetheless, the Bank decided to keep interest rates unchanged, in the expectation that demand would shrink relatively rapidly in the near future and the current account deficit would narrow, and that this trend would serve to strengthen the exchange rate. At the same time, various signs were considered to suggest that very high interest rates could undermine the position of financial institutions. Since then, inflation prospects have improved somewhat and the exchange rate has begun to appreciate. A counteracting factor is recent figures for turnover in the economy and on the labour market, which suggest that demand growth will contract more slowly than had been previously hoped, cf. the article on Economic and Monetary Developments and Prospects. Thus the Bank does not identify grounds for a further reduction in interest rates for the time being. However, as always, it will remain alert to all the pointers that may shed light on the economic outlook. Furthermore, the Bank reiterates its view that success in containing inflation will inevitably call for the overheating to subside, which entails some reduction in economic growth for a while. In this context it should be remembered that according to the new Central Bank Act and the joint declaration with the government of March 27, the Central Bank shall target its actions first and foremost at achieving its inflation target, while taking financial stability into account. Thus the main objective of monetary policy is clearly a reduction in the inflation rate.