Introduction

Tight monetary policy and financial stability

Inflation is now unacceptably high, at more than 5½% over the past 12 months. Inflation has remained high even though the Central Bank increased its interest rates last year by a total of 1½ percentage points, which contributed to a 2.8% appreciation of the króna. Without these actions, the inflation rate would have been even higher. However, the Bank's interest rate rises hardly sufficed to match greater inflationary expectations during the final months of the year. The Bank therefore raised its interest rates yet again, by 0.8 percentage points in mid-January and by 0.3 percentage points once more in mid-February. In consultation with the Government, the Bank also widened the exchange rate band from 6% to 9% in either direction from the central rate. These measures relay a clear message that reducing inflation takes priority in the design and implementation of monetary policy.

In January this year, the Central Bank forecast an inflation rate of 5% between 1999 and 2000 and 3.8% in the course of this year, assuming an unchanged exchange rate from the date of the forecast. Inflation is therefore running two to three times higher in Iceland than among its trading countries. This development is not acceptable, since such high inflation will undermine the competitiveness of Icelandic industries and present living standards. Thus it is important for economic policy measures and wage settlements to aim towards reducing inflation. In the immediate future, exchange rate developments will be crucial. Wage settlements must also take the strengthening of the króna into account by agreeing to lower wage rises, since a higher exchange rate and lower inflation will lead to higher real wages.

The real exchange rate has risen recently as inflation has increased and the nominal exchange rate has appreciated, in particular in the second half of last year. The real exchange rate in terms of consumer prices is now at its highest level since March 1993, i.e. before the devaluation in June that year which in fact brought it down to a historical low. The real exchange rate in the last quarter of 1999 was close to the average for the past 20 years but well below the peak in 1987 and 1988. A substantial increase in exports of manufactured goods excluding products of power-intensive industries, fairly good business profitability and a high rate of employment do not suggest that the real exchange rate has risen to a long-term unsustainable level. The large current account deficit is primarily caused by excessive demand growth. However, there is a risk of the real exchange rate rising further and export and competitive industries becoming temporarily squeezed between an overheated economy and a tight monetary stance. Tighter fiscal policy and a smaller current account deficit would reduce this risk. In this context, it is particularly important that expenditures do not overshoot the budget and that any excess treasury revenues be used in full to improve the fiscal balance further. Furthermore, it is vital that any measures taken by the government to facilitate a moderate wage settlement should not reduce the budget surplus.

In this issue of Monetary Bulletin, the Central Bank publishes for the first time its assessment of the position of the financial system as a whole and the risks it may face. The conclusion of this analysis is that the probability of credit institutions encountering difficulties in the near future is fairly small, since economic conditions are favourable. However, recent excessive credit expansion, coupled with a deterioration in their equity ratio, makes credit institutions more vulnerable to economic setbacks. The large current account deficit and relatively sensitive foreign short-term position are signs of weakness, although the short-term position has improved, in part because of the Central Bank's actions. The main risk is that in the long run a large current account deficit could undermine credibility of economic policies and the stability of the exchange rate. Hence, the most important task in the area of financial stability is to contain credit expansion and reduce the current account deficit. These tasks are also compatible with the goal of ensuring long-term price stability. Thus there is at present no conflict between the Central Bank's twin roles of promoting a low rate of inflation and financial stability.