Introduction

Rise in interest rates aims at lower inflation

The Central Bank of Iceland raised its policy rate by 0.8 percentage points on November 1, 2000. Yield on the Bank's repurchase agreements with credit institutions rose to 11.4% as a result. This is the highest policy rate that has been seen in Iceland since the disinflation at the beginning of the 1990s. It is also the highest rate of interest relative to inflation expectations and foreign short-term interest rates for a very long while. Offsetting this is the considerable depreciation of the króna which took place in the autumn. This depreciation was not caused by an easing of the monetary stance, but rather by a fall in the equilibrium rate of the króna following a cut in catch quotas and a poorer economic outlook. At the moment the monetary stance is probably tighter than at any time since the present financial market and monetary framework were established in the mid-1990s.

Behind the Central Bank's decision lay the worsening inflation outlook for next year caused by the weakening of the króna and sustained pressure in the goods and labour markets. Besides the reasons pointed out above, the depreciation was also prompted by the fact that rising foreign interest rates had narrowed Iceland's short-term differential with its trading countries by more than half a percentage point from the middle of the summer, or from just under 6½% after the rise announced by the Bank in June to just under 6% on October 31. At the end of October, the króna had depreciated by 7.3% since the beginning of the year. The impact of the rise in interest rates was immediately reflected in the exchange rate of the króna, which strengthened by 0.6% on November 1.

Inflation was much lower during the third quarter than had been forecast. Measured in terms of the twelve-month rise in the CPI, inflation slowed down sharply from the spring. The gap between inflation in Iceland and its trading countries narrowed at the same time when foreign inflation gained momentum, among other things because of rising oil prices. Iceland's price outlook has deteriorated, however, since the króna is weaker now than in late summer. The Central Bank now forecasts inflation of just over 5% between 2000 and 2001, but 4.6% during next year. On the other hand, assuming that the exchange rate remains unchanged, the outlook is that inflation will slow down to 3% in 2002. But since the impact of the most recent Central Bank interest rate rise has only partially been delivered so far, it could still suffice to bring inflation in 2002 down to a similar level to that of Iceland's trading partners, as is the aim.

The labour market is very tight and is becoming even more so. This takes the form of a record number of vacant positions and historically very low unemployment figures. There is a risk that this tension will break out in growing wage drift. Large-scale influx of labour from abroad has nonetheless prevented such a development so far, and poorer business performance and higher interest rates may conceivably keep wage drift in check in the near future. Labour market pressure is, however, an important risk factor for the inflation outlook. The same applies to the ongoing big current account deficit which, coupled with strong currency outflows because of foreign investments by pension funds and other parties, has a tendency to undermine the exchange rate. Indications of a significant downturn in productivity growth are also a cause for concern. If this continues, there is a risk that wage rises will have a bigger inflationary effect.

Turnover growth has according to VAT returns slowed down since last year and activity in the housing market has also cooled considerably. In the case of the property market, this is partly due to the impact of higher interest rates resulting among other things from the tight monetary stance. Poorer prospects for export production, the higher level of interest rates, lower share prices, growing debt service burden, greater tax burden and less general optimism will probably serve to dampen the expansion in demand even further next year. Economic growth is therefore likely to show a significant decline compared with this year. Another contributing factor is the fiscal stance, which has been tightened over the past two years. Domestic demand would have expanded much more without it. In light of robust domestic demand and the wide current account deficit, it would in fact have been preferable to tighten the stance even further. Next year will witness a slight further tightening of fiscal policy.

Credit expansion has still not slowed down. The twelve-month increase in lending by deposit money banks until the end of September was actually greater than in the first half of this year. To some extent this could be explained by the impact of the exchange rate depreciation on the banks' foreign-denominated lending and by direct lending abroad by domestic credit institutions. The sharp rise in lending is a cause for concern, not only because it kindles overheating of the economy at the domestic level, but equally because it entails a greater risk for the domestic financial system if economic and real income growth slows down sharply or even contracts. Foreign borrowing by the banks for relending remains one of the main causes of the credit expansion. This is accompanied by an additional risk for financial stability, especially if it is based to a significant degree on short-term funding. This issue of *Monetary Bulletin* includes special coverage of developments this year concerning major factors relevant for financial stability.

As pointed out above, in terms of interest rates the monetary stance at the moment is the tightest since the present financial market and monetary framework were established. Based on the inflation premium on treasury bonds, the Central Bank's real policy rate is now 5½%, and the short-term differential between Iceland and abroad is almost 6½%. Furthermore, foreign interest rates have risen and so have spreads faced by domestic borrowers. Other important points are the recent sizeable rise in indexed long-term rates and the fact that, before the Central Bank raised its own rates, the commercial banks and savings banks' unindexed rates had outpaced them since the beginning of this year. Thus it is now more difficult than before to sidestep tight Central Bank interest rates by foreign borrowing or by taking indexed domestic loans. The impact of the higher policy rate is now being felt with full force and will contribute to easing demand and consolidating the basis for price stability in the near future. The Central Bank will maintain its tight stance until unquestionable signs emerge that the economy is cooling down and inflation is definitely heading towards the level prevailing among Iceland's trading partners.