Introduction

Increased likelihood of the Bank's inflation target being attained in 2003 – Interest rates cut

National expenditure has begun to decline and a further reduction is necessary in order to close the output gap and bring the current account deficit back to a sustainable level. Better balance will then be established in the Icelandic economy and the foundations for stability and low inflation will be strengthened. A contraction in economic activity, which will emerge next year in the form of lower GDP than this year, will inevitably accompany this development. The extent of the recession in 2002 is uncertain. Very high economic growth in 2000 and the first half of this year increases the probability of a sharper contraction than would otherwise have been the case.

There are various signs now that the economy is cooling. The drop in imports and retail turnover are two examples. Another important factor is that the sharp credit expansion of recent years has now largely come to a halt, ignoring the automatic rise in the outstanding loan stock caused by inflation and the exchange rate depreciation. Excluding these adjustments, annualised deposit money bank (DMB) lending grew by only 5% over the six months until the end of September, and shrank somewhat in the last three months. There are indications that pension funds and investment credit funds have increased their lending by more than the DMBs in the past few months. Nonetheless, most signs suggest that the underlying growth in lending by the credit system as a whole has recently eased substantially. Slower credit growth points towards a further easing in demand in the near future. The labour market remains relatively tight and wage drift in the private sector peaked during the third quarter. However, there are clear signs that labour market pressures will ease in the months to come.

Broadly speaking, the Central Bank's inflation forecast for Q3 was on target. Nonetheless, the Bank has upped its inflation forecast somewhat for this year and next, on account of greater wage drift and a lower exchange rate than was assumed in its previous forecast. Inflation is now forecast at 8½% from the beginning to the end of this year and 4% next year, compared with just under 3% in the Bank's August forecast. All the same, the probability of the Bank's inflation target being attained in 2003 is now greater than before, since the signs that the economy is cooling are much more explicit and the outlook is that the output gap will become negative as next year progresses. However, uncertainty still prevails, due to the conceivable review of wage agreements next year.

The exchange rate of the króna has been under some pressure in recent weeks. At the end of October it was more than 5% lower than at the end of July, despite the Central Bank selling currency totalling almost 10 b.kr. during this period to support the króna. In the short term, market conditions could be unfavourable for the króna, especially if the inflow of capital which is necessary to finance the current account deficit shrinks faster than the deficit itself. Thus it is impossible to make a short-term forecast for the level of the exchange rate, any more than for the exchange rates of other currencies. The Central Bank has previously stated its view that the real exchange rate of the króna is now much lower than the expected long-term equilibrium exchange rate, and will therefore increase in the near future. However, it is uncertain when this will take place and to what extent it will come about through a higher nominal exchange rate of the króna or higher inflation than among trading partner countries.

The outlook is for a deterioration in the fiscal balance this year, over and above what is caused by lower GDP growth. The reason is a large increase in treasury outlays due to specific expenditure decisions and large public sector wage increases, and a decrease in revenues on account of lower levels of consumption and imports. All things being equal, this trend, coupled with the economic recession, could reduce the surplus aimed for in next year's draft budget. The Central Bank reiterates its view that it is still untimely to ease fiscal policy or adopt other measures to spur demand. National expenditure is too high and will remain so next year, according to current forecasts. Thus it is important for the parliamentary process to secure the outcome that was envisaged in the budget proposal for next year.

As pointed out above, the Central Bank regards any measures to spur demand as untimely. In its June report to the Government on the inflation target[1], however, the Central Bank considered that measures "which strengthen the supply side of the economy, i.e. increase the supply of factors of production (labour and capital), boost productivity and encourage savings … would simultaneously create preconditions for sustained growth and support the Bank's inflation target." Proposals for reforms to the tax system which the Government announced at the beginning of October partly fulfil these conditions. They entail lower taxation of capital deployed in business operations and higher taxation of labour, which is sensible in an economy that has been characterised by excess demand for labour and inadequate national saving. Furthermore, they will contribute to a capital inflow due to direct investments, although the extent of this impact remains unclear, especially at first. However, in the Bank's view it would be desirable, under the prevailing conditions, to increase other taxes more to offset this, or to cut back treasury expenditure. A compensating factor is that the treasury's loss in revenue will not appear in full until 2003, by which time some slack should have developed in the economy according to current forecasts. Thus the Bank does not consider that the above plans undermine the economic balance or jeopardise its inflation target.

Measured in terms of the inflation premium on treasury bonds, inflation expectations have fallen recently. The inflation premium on treasury bonds is now in line with the Central Bank's inflation forecast. The credibility of the Bank's inflation target has improved correspondingly. At the same time, there has been a substantial widening of the short-term interest rate differential with abroad. Accordingly, the monetary stance has tightened, and the Central Bank policy rate towards the end of October was marginally higher in real terms than it was following the interest rate cut on March 27. Higher real Central Bank interest rates, lower inflation expectations, clear signs of a cooling economy, much slower credit growth, a deteriorating economic outlook and interest rate declines in trading partner countries, the expected emergence of a negative output gap and an increasing likelihood of the inflation target being attained in 2003 all speak in favour of an interest rate cut. Consequently, the Central Bank has decided to lower the interest rate in its repo auctions by 0.8 percentage points. A tight monetary stance will still be maintained, however, since the Bank's real repo rate will be about 6½% after this change. As ever, the timing and scope of further interest rate cuts will be determined by economic developments and by the probability that the Bank's inflation target will be achieved in 2003.

1. See *Monetary Bulletin*, August 2001.