Monetary Bulletin 2003-3

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Introduction

Monetary policy reflects economic recovery and low inflation, but also some uncertainty

An economic recovery has begun and most indications are that the upswing will gain momentum during the coming winter. GDP growth was robust at 3.3% during the first quarter and there are signs that it continued in the second quarter, but possibly at a slightly slower pace. However, the output gap is still negative and seasonally adjusted unemployment has not fallen. Leading indicators such as credit growth nonetheless strongly suggest that demand will continue to increase in the near future. The inflation rate has been low and below the Bank's target for the whole of this year. Core CPIs, which exclude volatile items and others which monetary policy is obviously incapable of affecting, also show that inflation is below the target, although much closer to it. The present low inflation is partly to be explained by the appreciation of the króna towards the end of last year and for most of this year, and lower-than-expected global inflation.

Interest rates, the exchange rate and asset prices have tended to move in the direction of easing since the last *Monetary Bulletin* was published in May. Indexed bond rates have fallen and banks subsequently lowered their indexed deposit and lending rates. Non-indexed bond rates have also gone down, and the same applies to interest rates in many other countries. On the other hand, the short-term interest rate differential with abroad has widened. The króna has nonetheless depreciated since May, probably in part due to increased regular foreign currency purchases by the Central Bank in the domestic interbank market which were announced in the last *Monetary Bulletin* in May, but also for other reasons. Equity prices have continued to climb.

No major changes have occurred in the assumptions or results of the macroeconomic forecast since May. Slightly higher GDP growth is expected this year and in 2004, among other things because of larger fish catches this year and a weaker exchange rate than assumed in the last forecast. GDP growth is now forecast at 2¾% this year and 3½% next year. Since this year's growth rate is below estimated potential, the output gap will turn slightly more negative this year compared with 2002, then move to marginally positive next year and subsequently widen further. On the basis of these assumptions along with an unchanged exchange rate and Central Bank policy interest rates, inflation is now forecast some way below the target for the whole of next year, but will creep above it two years hence, i.e. in Q2/2005.

As always, the inflation forecast is fraught with uncertainties. It assumes that the Norðurál aluminium smelter expansion will go ahead, even though this is not definite. If this investment fails to materialise, GDP growth could end up ½% lower than forecast this year and ¾% lower next year. The slack in the economy would then be correspondingly larger this year and the output gap would not be closed up in 2004. Global inflation could also prove lower than assumed here. However, mounting pressure in the labour market as aluminium-related investments approach is not assumed to provoke wage drift on any great scale or significantly affect negotiated wage rises. On the contrary, wage rises this year and in 2004 are predicted to be lower than in recent years, with private sector wage costs increasing from the previous year by 5% and 4¼% in 2003 and 2004 respectively. This implies that moderate wage rises will be negotiated in settlements at the beginning of next year and that bottlenecks which may form in certain labour market segments will be promptly countered with imported labour. If this scenario does not materialise, inflation will looking further ahead be higher than forecast here, assuming an unchanged policy interest rate.

Uncertainties surround the fiscal and housing loan policies which will be announced shortly. The inflation forecast is based on the assumption that fiscal policy will not deliver a stronger demand impulse than has already been decided with job creation schemes by expediting public sector construction projects. It is assumed that growth in public consumption will remain below the historical average and that the Treasury balance will not be disrupted by discretionary measures on the expenditure or revenue side. Nor are any changes allowed for in housing financing arrangements which could drive up housing prices and stimulate aggregate demand.

If the Treasury balance deteriorates due to measures on the expenditure and/or revenue side, inflation will exceed the forecast here. Interest rates would then need to rise earlier and by more than otherwise, which would be highly unsuitable by contributing to a higher exchange rate and thereby squeezing export and import-competing industries even further. On a longer-term view, the Government needs to present a plan looking several years ahead for measures to counteract the impact of the aluminium industry investments. The Ministry of Finance has announced that it is working on such a plan which will presumably be presented this autumn at the latest, alongside the Budget. The contents of this plan will be a major determinant of the timing and scale of interest rate increases in Iceland in the medium term. In this context, it is important to avoid tax cuts in the next few years unless they are fully offset by cuts in government spending or rises in other taxation.

In its policy statement this spring, the new Government announced that the mortgage ceiling of the Housing Financing Fund for ordinary housing will be raised in stages during its term of office to as much as 90% of the value of the property, and raising the maximum loan amount has also been mentioned. At present it is not known how this policy will be implemented. However, it is crucial to bear in mind that, in the current circumstances, changes of this kind can have a comparable effect on the exchange rate and monetary policy to an easing of the fiscal stance. Monetary policy would then need to respond with higher interest rates than otherwise, causing the exchange rate to appreciate. In the present scenario it would not improve the situation if non-residents were to finance housing transactions indirectly by stepping up their purchases of housing bonds, because of the risk that the króna would strengthen even further, at least temporarily. This would also create a risk that non-residents might divest housing bonds from their portfolios if they were prompted to reappraise the investment risk in Iceland following a temporary economic contraction when construction projects for the aluminium industry come to an end. This could conceivably amplify downward pressures on the króna which might be present then in the downturn at the end of the aluminium industry investments, and force up interest rates in direct contradiction to the movement of the business cycle. Such a development could conceivably also create financial instability in addition to the problems of demand management. Thus it is crucial to make an in-depth examination of the macroeconomic impact of these plans before they are launched.

The Governors of the Central Bank of Iceland do not consider that there are grounds for altering interest rates now, given the analysis and inflation forecast presented here. A forecast that inflation two years ahead will be above target is not sufficient reason in this case for raising interest rates. The small deviation and the high degree of uncertainty also have to be taken into account. Therefore the low rate of inflation at present and probably in the near future matters. Regarding deviations from the inflation target, it is important to bear in mind that a successful and credible monetary policy gives more weight to long-term than to short-term considerations, and that it is neither possible nor optimal to fine-tune the inflation rate with excessively volatile interest rates.

As stated in the last edition of *Monetary Bulletin* in May, the most likely outlook is still that interest rates will remain unchanged for the time being, then rise as the peak of aluminium-related investments approaches. However, the point at which it may be necessary to raise interest rates could be further away than was foreseen then, since inflation has been very low recently and will continue to be so, for reasons including low global inflation and a greater slack in the economy. As always, the outcome will depend on future developments and in particular on the fiscal and housing finance policies to be announced shortly. In light of the present low rate of inflation, however, it cannot be ruled out that negative shocks to domestic demand and to imported inflation might call for a temporary reduction in interest rates from their present level. This could occur, for example, if proposed investments in connection with the Norðurál smelter expansion do not go ahead, if domestic demand driven from other sources than aluminium industry investments turns out much lower than is currently expected, or if deflationary pressures continue to build up in the global economy. Monetary policy will be reassessed when the occasion demands, and in particular when the fiscal and housing finance policies are made public. It should also be reiterated that phase two of the reduction of deposit money banks' required reserves in the Central Bank, which was outlined in *Monetary Bulletin* in February, will be implemented before the end of the year as previously announced.