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**The Central Bank of Iceland publishes Monetary Bulletin and lowers interest rates**

On November 6, 2002, the Central Bank of Iceland published the November issue of Peningamál (Monetary Bulletin), including the Bank’s quarterly inflation forecast, and for the first time, a macro-economic forecast as well. Inflation has continued to slow down over the past quarter and the Central Bank’s inflation target should be attained by the end of the year. According to the Bank’s forecast, price stability will also prevail for the next two years.

GDP growth is expected to be sluggish next year, at 1½%, but recovery will likely gain some momentum in 2004. A growing slack in the economy will emerge as growth remains below potential. This and favourable external balance should contribute to exchange rate stability as well as price stability over the forecast period. This issue of Monetary Bulletin includes a discussion on the problems that uncertainty concerning conceivable large scale investment projects in hydropower and power-intensive industry pose to the conduct of monetary policy.

On the basis of the forecasts and analysis published in this issue of Monetary Bulletin,

the Board of Governors of the Central Bank of Iceland decided to lower the yield in the Bank’s repurchase agreements with credit institutions by 0.5 percentage points, to 6.3 percent, effective at the next auction of repurchase agreements on November 12, 2002.

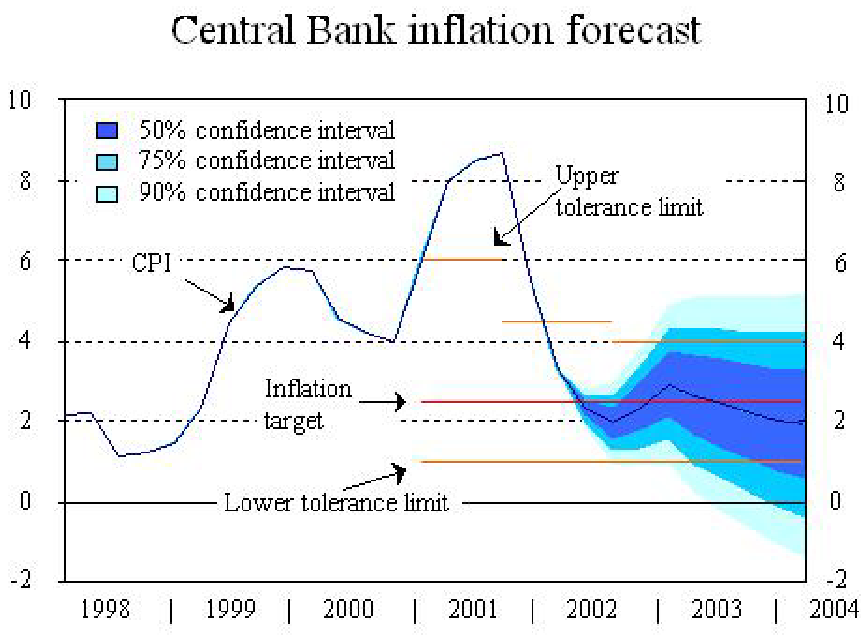
The English translation of Peningamál, Monetary Bulletin, will appear on the Bank's website, each chapter as soon as it becomes available. Attached is a preliminary English translation of the Bulletin's introductory chapter.

## Consumer price inflation in Iceland 2000 to 2004

| | *Annual percentage change* | |
|---|---|---|
| | *Year on year* | *In the course of the year* |
| 2000 | 5,0 | 3,5 |
| 2001 | 6,7 | 9,4 |
| 2002 | 4,9 | 1,7 |
| 2003 | 2,5 | 2,5 |
| 2004 | 2,1 | 1,9 |

Quarterly forecast (four and eight quarters ahead)

| | Annualised quarterly change | Percentage change from year ago |
|---|---|---|
| 2002 Q-3 | 0,7 | 3,3 |
| 2003 Q-3 | 2,9 | 2,9 |
| 2004 Q-3 | 2,2 | 2,0 |



*Preliminary translation of the introductory chapter in the November 2002 issue of the Central Bank of Iceland's Monetary Bulletin:*

Inflation has continued to slow down over the past quarter. If inflation for the remainder of the year follows the recent trend, the Central Bank's inflation target will be attained by the end of the year. According to the inflation forecast published in this issue of *Monetary Bulletin*, price stability will prevail for the next two years, although inflation may rise slightly but temporarily around the middle of that period. The inflation forecast is based on the Central Bank's own national economic forecast, which is now published for the first time. According to the forecast, national expenditure will contract by just over 3% this year, while favourable external trade will maintain economic growth close to zero. GDP growth will be sluggish next year at 1½%, but the recovery is expected to gain some momentum in 2004. The growth rate of output is expected to be below the long term growth rate of potential output, causing growing slack in the economy, not least in the labour market. Under such conditions, wage changes are likely to be moderate. Furthermore, favourable external balance ought to contribute to exchange rate stability. The current account deficit is expected to be negligible for the next two years. These conditions will contribute to price stability over the period. As ever, considerable uncertainty surrounds many aspects of the forecasts, for example concerning the terms of trade and external conditions of the economy in general. Nonetheless, the greatest uncertainty involves conceivable large scale investment projects in hydropower and power-intensive industry.

The inflation forecast and the national economic forecast are based on the assumption that proposed aluminium smelting and hydropower projects will not start during the forecast period. Insufficient information was available about these projects in time to allow a thorough assessment of their economic impact, as was originally planned for this *Monetary Bulletin*. An assessment will be made as soon as the necessary information is available, and will probably be published in the next issue. Although no decisions on these projects have been made, there is substantial probability that the go-ahead will be given. This causes some problems for forecasting and monetary policy formulation. If the projects go ahead, all assumptions will change fundamentally. One option is to take account of conceivable projects in interest rate decisions at this early stage. However, the Central Bank does not regard this as timely yet, given the uncertainty still prevailing concerning the outcome of negotiations, the timing and scale of the projects. The Bank's view is based on the premises that the welfare loss caused by an excessively tight monetary stance, in case the projects are not launched next year, is likely to exceed the loss due to excessively loose monetary policy once a decision to go ahead is announced. There are three main reasons. Firstly, the slack in the economy will increase next year if the projects are not realised. The monetary stance is currently too tight given that assumption, which imposes a risk of an unduly deep economic downturn if monetary policy in the near future partly reflects large scale projects, which then fail to materialise. Secondly, some time still remains until the decision on the projects is made, and it will be even longer until any substantial effect on demand and inflation will be felt, which gives sufficient time to respond. Thirdly, monetary policy can respond quite swiftly. As soon as decision is made interest rates could be raised quickly.

The Central Bank's twice-yearly study of financial stability is included in the current *Monetary Bulletin*. This reveals that various risks which the financial system may have faced over the past year have continued to diminish. To a large degree this can be attributed to disinflation and better domestic and external macroeconomic balance, which has put the finances of household and business on a firmer footing and made exchange rate stability more likely. However, repercussions of the period of overheating, which ended last year, are still being felt. Many households and businesses have stretched their finances to the utmost, which makes them vulnerable to shocks in the years to come, e.g. caused by a downturn in external conditions. The increase in the number of unsuccessful distraint actions and bankruptcies, and growing defaults with credit institutions, testify to the vulnerable position of many households and businesses, which may affect the financial system in coming years. All the same, financial stability does not seem to be at risk, since the equity position of the main institutions has strengthened from its low at the end of 2000.

The monetary stance, as reflected in the Central Bank's policy interest rate in real terms, has eased considerably in recent months, after four interest rate cuts by a total of 1.7 percentage points over the period from August to October. Those cuts were based on the analysis and inflation forecast presented in the last *Monetary Bulletin*, which suggested rapid disinflation and greater slack in the economy. Developments hitherto have confirmed this analysis, as pointed out above. The Central Bank policy rate, however, is still probably close to the upper limit of what can be regarded as the equilibrium rate of interest, i.e. a suitable long-term interest rate for conditions where inflation is consistent with the Bank's objectives and there is neither a positive output gap nor slack. The reason is that quite recently the rate of inflation was running fairly high, which severely restricted the Central Bank's scope for taking the poorer economic outlook into account.

In light of the assessment of economic conditions and outlook as presented here, the Bank has decided to take yet another step in cutting interest rates. The crucial factor behind this decision is that forecast inflation over a two-year horizon will remain below the Bank's inflation target, and slack in the goods and labour markets is expected to increase next year. The repo interest rate will therefore be lowered by 0.5 percentage points as of November 12, 2002. On the basis of the current forecasts, if confirmed by subsequent developments, the Central Bank's policy rate could come down even further in the near future. However, it must be cautioned, the lower the rate of interest, especially if it is clearly below the long term equilibrium level, the more the Bank will need to take the potential resulting stimulus into account. Furthermore, once a decision has been made about power-intensive industrial projects a fundamental review of monetary policy will be warranted.