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Introduction

Interest rate rises on the horizon

Economic developments so far this year have been characterised by strong growth of national expenditure, in particular private consumption and investments connected with the aluminium industry. The terms of trade have worsened as a result of falling prices of marine products and higher fuel prices, and exports have been weak, led by a contraction in marine products. Accordingly, national expenditure is now forecast to increase this year by considerably more than was forecast at the end of July, or 5¼%, and output growth by less, or 2%. As a consequence, this year's current account deficit will be wider than was forecast in July, at 3½% of GDP. The current account deficit is still not a cause for concern, since it partly reflects imports for aluminium-related investments and a temporary contraction in fish catches. However, the deficit needs to be monitored in the coming term, and the brisk growth in imports of consumer goods in recent months is a cause for reflection. The explanation may be that private consumption growth was driven by overoptimism in the first half of the year. On the other hand, further widening of the current account deficit cannot be avoided while aluminium-related investments approach their peak. The deficit does not give grounds for concern as long as it does not grow substantially beyond what is warranted by the aluminium industry investment programme, for example through unrealistic increases in private consumption.

The level of GDP growth forecast this year is below output capacity, so that the output gap will turn more negative than in 2002. Seasonally adjusted unemployment has consequently not decreased and some slack remains in the labour market. Since the króna strengthened for the first part of the year and has been quite stable recently, inflation has also remained quite steady, just below the Bank's inflation target and well in line with forecasts made earlier this year. Core inflation indices measure inflation as marginally above the target, while inflation expectations are very close to it.

This edition of *Monetary Bulletin* contains the Central Bank's macroeconomic and inflation forecast until the end of 2005. As usual it assumes an unchanged policy interest rate and unchanged rate of exchange. Assumptions for fiscal policy are broadly in line with the government's budget proposal for 2004 and long-term programme for the period 2005 to 2007. The macroeconomic forecast does not take into account the proposed expansion to the Norðurál aluminium smelter, which was included in the July forecast. While there is probably more likelihood now than then that the expansion will go ahead, the project now under consideration differs in some respects from earlier plans and the investment is spread differently over the forecast horizon. For this reason, and because

the project has still not been finalised, it was decided not to incorporate these investments into the main forecast. Activity on the Fjarðaál project in East Iceland has been rescheduled, with less investment in the smelter and hydropower facilities in 2005 and 2006 but more in 2007 than had previously been assumed.

According to the macroeconomic forecast, output growth in 2004 will be 3%, which is a lower figure than in the July forecast. The output gap will therefore remain negative next year, although unemployment will drop below 3%. On the other hand, growth will firm up in 2005 and be well above growth in output capacity. The output gap will therefore turn positive and unemployment fall below 2½%, fuelling pressure in the labour market. Inflation will gain momentum over the forecast horizon, but is expected to remain below the Central Bank's target for the whole of next year. Two years ahead, however, inflation will inch above the target. If the Norðurál expansion goes ahead in the next few months, annual output growth will be ½% greater in both 2004 and 2005. In that case, the output gap will be closed by next year, and inflation will exceed the target sooner and by more than otherwise.

The budget proposal for 2004 involves a sizeable tightening of the fiscal stance compared with the current year. This tightening is necessary to prepare the ground for the aluminium-related investments and support monetary policy. Experience in recent years has shown that the Treasury revenue balance tends to shrink between the budget as proposed to parliament and its final outcome, especially after cyclical adjustment, so that the stance does not turn out to be as tight as originally aimed for. It is vital to ensure that the tighter fiscal stance implied by next year's budget remains intact. If not, monetary policy will come under more strain and interest rates will rise sooner and by more than otherwise, with a corresponding effect on import-competing and export industries.

In spite of tax reductions, the cyclically adjusted Treasury surplus will increase even further in 2005, according to the Treasury's long-term programme, because these will be outweighed by cutbacks in public consumption, transfers and investment. However, things will take a turn for the worse in 2006 and the cyclically adjusted result will deteriorate considerably when the second phase of tax cuts is implemented at the same time as central government infrastructure investment is stepped up again. It would be most unfortunate if this scenario materialises. According to the most recent estimates, aluminium-related investment activity will peak in 2006; it will outstrip the level of 2005, whether the Norðurál expansion project is realised or not. Experience shows that the final year of an upswing generally poses the greatest risk to economic and financial stability, and is therefore not an appropriate time to ease fiscal policy. There is a risk that monetary policy will come under intense strain in 2005 and 2006. It is vital to take full account of this in the review of fiscal plans when budgets for the coming years are drafted.

In its last *Monetary Bulletin* in August, the Central Bank pointed out the conceivable expansionary effect of plans to raise mortgage levels for ordinary housing to as much as 90% and increase the maximum loan amounts. In the prevailing climate, such changes could have a similar effect on the exchange rate and monetary policy to an easing of the

fiscal stance. This standpoint has not changed. It is clear that these changes could have a greater effect in the short term than in the long run. This suggests that timing will be crucial for their impact. A cautious approach is vital for as long as the economy is overstretched by aluminium-related investments. Further consideration of this issue is impossible at present, however, since final proposals for housing loan changes are unclear at the time of writing.

At the end of summer 2002 the Central Bank identified an opportunity to make regular currency purchases in the domestic foreign exchange market with the aim of strengthening its foreign exchange reserves. Accordingly, the Bank began buying foreign currency in autumn 2002. In the course of that winter, decisions to construct an aluminium smelter and hydropower plant in east Iceland created conditions for stepping up currency purchases, which was done in phases until May this year.

The Central Bank's assessment of the required minimum foreign exchange reserves is now in the region of 50 b.kr., which will be amply reached, all things being equal, at the end of the year. Further strengthening of the reserves in the years to come is also warranted by such factors as Iceland's level of foreign debt. In the Central Bank's view, conditions for doing so will still be in place next year, although currency will be purchased on a much more moderate scale after the beginning of 2004 than since May this year. Accordingly, the Bank aims to purchase 5 million US dollars weekly in the domestic interbank market next year. Roughly half of this figure will be in connection with the Treasury's foreign debt service requirement. All things being equal the foreign reserves will be strengthened by the equivalent of roughly 10 b.kr. during the year. At the beginning of 2004 the Bank's weekly currency purchases will therefore be reduced by 60% from their level since May and until the end of this year.

As a rule, currency purchases by the Central Bank mop up liquidity in the domestic money markets. Hitherto, the effect of these purchases has been counteracted by a reduction in the credit institutions' repurchase agreements with the Bank. To some extent this is an automatic process, since it is ensured that repo interest rates do not change despite the currency purchases. Such counteraction cannot be relied upon entirely, however, especially not in the short run. The Bank can take other measures to sterilise the liquidity effect of its currency purchases and will do so if necessary in order to prevent them from causing domestic monetary expansion. This determination underlines even further that the Bank does not regard its currency purchases as constituting part of its monetary policy or as an instrument to influence the exchange rate, but makes them with the sole aim of taking advantage of favourable conditions to bring its foreign exchange reserves up to a desirable size.

In its last three analyses of financial stability in *Monetary Bulletin*, the Bank has identified successive reductions in risk and a strengthening of the financial system's capacity for withstanding conceivable shocks. Financial companies have strengthened their positions still further since the last analysis, which was published in May, and are better equipped against setbacks. The character of the financial system has changed

notably in recent times in the wake of privatisation and mergers. It has become more dynamic and must rely on its own resources for building up strength and facing shocks.

Some risk to financial stability will be posed by the economic impact of the aluminium-related investment activities which have now begun, and by the uncertain scenario on their completion. The timing and scope of the necessary countervailing measures will also be crucial. In the coming years the main risk faced by the financial system lies in failing to contain inflation, which would fuel volatility in real interest rates, the exchange rate and demand. If measures to constraint inflation are not taken in good time, the risk is that households and business will suffer a more difficult adjustment, and be left in a worse position at the end of the investment period, than if a monetary policy is pursued which aims at keeping inflation as close as possible to the target while investment activity is under way. In a worst-case scenario, a lax stance which called for correspondingly tougher measures later could jeopardise financial stability. In the Central Bank's view, financial stability is satisfactory but overall there are no grounds for claiming that the position is stronger than when the last analysis was published in May.

The new macroeconomic and inflation forecast implies that higher interest rates are on the horizon. The present negative output gap will turn positive by the first half of 2005 at the latest and inflation will move above the target then, assuming that monetary policy remains unchanged. This will occur even sooner if work on the Norðurál smelter expansion begins next year. The factors described in the last *Monetary Bulletin* in August, which could even have led to a cut in interest rates, are no longer in place, since domestic demand has proved stronger than expected and the risk of disinflation among major trading partner countries has waned. Moreover, the Norðurál smelter expansion is now much more likely to go ahead than was foreseen at the end of July. Nonetheless, the Central Bank does not consider it the right time to raise interest rates at the moment. Certainly it is important to respond to looming inflationary pressures in good time, since a lag of one year may be expected before the impact of monetary measures on the price level is felt with any force and a further year before it is transmitted in full. On the other hand, the inflation forecast will be below target for the whole of next year, there is some slack in the economy and the Bank has lowered its output growth forecast for this year and 2004. There is still leeway over the next few weeks to assess whether developments confirm this outlook, including the degree of pressure created in the labour market by aluminium-related investments, which hitherto have had less impact than expected.

Interest rates will most probably be raised soon. As ever, interest rate developments in the near term will depend on economic developments, together with fiscal policy and any changes that may be made in housing loan arrangements. If the Norðurál smelter expansion goes ahead it will also have an impact.