

## *Introduction*

# Monetary policy aims at reducing inflation

With the weakening of the króna, inflation prospects this year have deteriorated since the spring. The Central Bank now forecasts inflation of just over 5½% in the course of the year. Assuming an unchanged exchange rate, inflation will slow somewhat in 2001, to just under 4% in the course of the year. This is a higher rate of inflation than among Iceland's trading partners and is unacceptably high. Over the next few months it will transpire whether inflation will drop faster as a result of lower petrol prices, easing of tension in the housing market and the cooling down of the economy. Figures for June, however, show that housing prices are still rising, and economic indicators offer no categorical signs that the economy is beginning to cool down. Economic activity could begin to slow down soon, prompted by the outlook for much lower growth next year, partly because of a fishing quota cutback, and events in the financial markets in recent weeks. However, there is no sign of the current account deficit shrinking very much in the near future. This will therefore be a risk factor which economic policy must address. Broadly speaking, the Central Bank's analysis presented in its last issue of Monetary Bulletin holds good.

The króna came under significant pressure in mid-June and again in the first part of July. Apparently, expectations that the króna could remain as strong as it was at the end of May dwindled as a result of the poorer prospects for fish catches, current account and inflation. On both these occasions the Central Bank intervened strongly in the interbank market. The aim was not to defend a specific exchange rate, but rather to prevent panic and short-term expectations from causing an abnormal and sharp depreciation of the króna, which could have led to excessive fluctuations. The króna fell by a considerable amount and at its lowest was just over 6½% down from the rate at the end of May, but then strengthened considerably in the second half of July.

The Central Bank's interventions were funded with foreign short-term credit and thereby weakened its net foreign position, while the foreign exchange reserve was kept steady. Even though the Central Bank has access to substantial foreign short-term credit facilities, it intends to strengthen its net foreign position again. The Bank will therefore use opportunities that arise to purchase currency in the interbank market without weakening the króna. Such currency purchases will therefore not reflect a determination on the part of the Central Bank to have any particular impact on the exchange rate.

On July 13 the interbank foreign exchange market was closed for two hours on the insistence of the majority of market makers. The Central Bank regards this closure as extremely regrettable and considers that rules on the interbank foreign exchange market need to be reviewed in order to prevent similar occurrences in the future.

The Central Bank raised its policy rate by half a percentage point on June 19. The interest rate differential towards abroad has remained at a historical peak as a consequence, but the monetary stance has eased somewhat in recent weeks with reference to real interest rates and the weaker króna. For as long as the inflation outlook does not improve and overheating remains persistent, the Central Bank will take a tight monetary stance. However, it will closely monitor conceivable turning points in developments. Monetary policy in the near future will aim to bring inflation down to a similar level to that among Iceland's trading partners one or two years hence. The trend of main indicators in the next few months will reveal more clearly whether it will prove necessary to tighten the monetary stance even further in order to achieve this aim, or whether the economy will cool quickly enough to allow the present degree of restraint or even a lower one to suffice.