Economic and monetary developments and prospects:[1]

Outlook for slower reduction in inflation than forecast this spring

Short-term inflation prospects have become somewhat bleaker by the fall in the króna since the spring. The Central Bank now forecasts an inflation rate of just over 5½% from the beginning to the end of the year. A further cause for concern is that inflationary expectations appear to be establishing themselves above 5%. Economic indicators do not provide any clear signs that the economy is beginning to cool. Economic prospects for next year and events in the financial market in recent weeks, however, could contribute to some cooling in the near future. Such a development would contribute to bringing down the inflation rate. On the other hand, there is no outlook that the current account deficit will narrow in the near term. It will therefore remain a risk factor to be addressed by economic policy. Broadly speaking, the analysis presented in the last issue of the Monetary Bulletin holds good. For as long as inflation prospects do not improve from the present state and economic overheating remains persistent, the Central Bank will pursue a policy of monetary restraint. It will, however, monitor conceivable turning points in developments very closely.

Inflation has remained above 5½% …

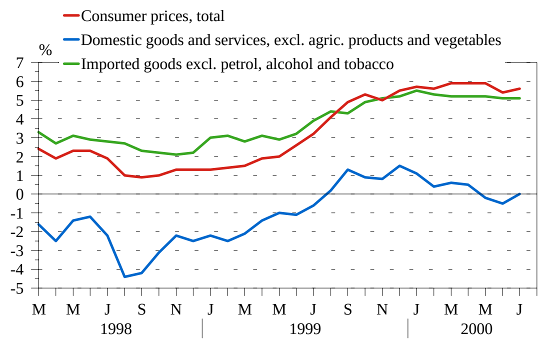
The twelve-month rise in the consumer price index has been in the range 5½-6% since December last year. From April to July, consumer prices rose by 1.3%, which corresponds to 5.2% inflation on an annualised basis. This is a somewhat higher rate of inflation than during the first quarter of the year. As has been the case for some time, higher housing and petrol prices played a major part in price rises during the second quarter. Something like half of the rise in consumer prices during the quarter may be explained by these two items. There are limits to the increase in petrol prices and the rise in housing prices is partially a correction of low prices in recent years. Thus it is clear that the underlying inflation rate has been lower than measured inflation in recent months.

However, this does not mean that inflation is not a problem in Iceland. Firstly, the rise in consumer prices during the twelve months until July, excluding housing, petrol and motor vehicle insurance, still amounted to 3.2%. This is almost double the inflation rate measured in these terms during the previous year, and also in excess of the EU average, which nonetheless includes petrol prices. Inflation in Iceland was in fact similar to that in Ireland in May,

Chart 1

Consumer price inflation

12 month % changes



1. This article uses data available on July 21, 2000.

or 5%, based on the harmonized EU CPI which includes petrol but omits housing. Secondly, large rises in housing prices are to some degree an indication of the demand pressure in the economy. Thirdly, there is a risk that higher headline inflation increases inflationary expectations and thereby helps it to take root.

Price developments during the second quarter were almost entirely in line with the Central Bank forecast published in May. The Bank forecast a rise in consumer prices of 1.4% between the first and second quarter then, which turned out to be the case. Thus there is no reason to revise the Bank's forecast for price developments in the next quarter on the grounds of any deviation. However, major changes in various assumptions, in particular the exchange rate of the króna, do give grounds for reviewing it, as will be discussed later.

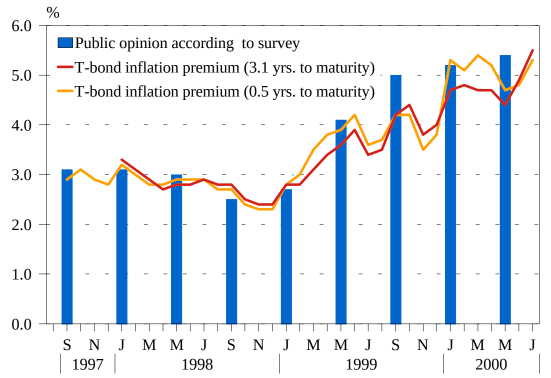
… and inflationary expectations above 5% are taking root

The higher rate of inflation in recent months has had an impact on inflationary expectations among the general public and financial market participants. According to a survey conducted by PricewaterhouseCoopers on behalf of the Central Bank three times a year, public expectations about inflation for the following twelve-month period have been at or above 5% since September 1999. The last survey, conducted in May, forecast an average of 5.4% inflation over the coming twelve months, which is a slight rise from the January forecast, although the median remains the same at 5%. It is interesting to note that respondents in the survey appear more convinced about inflation of 5% or more, since the standard deviation of inflationary expectations in the sample has been steadily decreasing since May 1999.

The inflation premium on treasury bonds, i.e. the spread between interest rates on unindexed and indexed treasury bonds, is another measure of the development of inflationary expectations. What distinguishes the inflation premium is that it represents the sum of inflationary expectations and a certain risk premium, which is probably positive, and it is formed over a longer horizon since the bonds have a lifetime to maturity of more than three years. The inflation premium has risen significantly in 2000, from just under 4½% at the beginning of the year to almost 6% after mid-July. Greater uncertainty and upheavals in financial markets have conceivably driven the risk premium up, although higher inflationary expectations are probably the main explanation for this trend.

Chart 2

Inflationary expectations 1997-2000



Experience shows that inflationary expectations keep pace with the real inflationary trend, although with a certain lag. However, the inflation premium on treasury bonds presumably implies a more forward-looking assessment than public inflationary expectations. Thus expectations about inflation will fall if inflation can be reduced. The risk is that the longer that inflation remains above 5%, the more firmly it takes root in expectations and subsequently has an impact on wage formation and other economic decisions. This in turn makes it more difficult to bring down inflation than would otherwise be the case.

Short-term inflation prospects have deteriorated

The Central Bank has produced a new inflation forecast for this year and next year in light of developments in recent months and a review of the main assumptions. The Bank now forecasts that inflation will run at 5.8% between 1999 and 2000, compared with the forecast 5.5% in May, and 5.6% over the year instead of 5% in May. Thus inflation prospects this year have deteriorated somewhat, mainly because the exchange rate of the króna in the current forecast is just over 5% lower than in the May forecast. The forecast is based on data available on July 21, including the exchange rate then. Other changes

Table I Inflation forecast of the Central Bank

Quarterly forecast

	Percentage change from previous year	*Index*	*Annualised quarterly change (%)*	*Change from same quarter previous year (%)*
1999:1	0.6	185.2	2.6	1.5
1999:2	1.5	188.0	6.3	2.4
1999:3	1.7	191.1	6.8	4.4
1999:4	1.4	193.9	5.9	5.4
2000:1	1.1	196.0	4.3	5.8
2000:2	1.4	198.8	5.9	5.7
2000:3	1.8	202.3	7.2	5.8
2000:4	1.4	205.2	5.9	5.8
2001:1	1.2	207.7	5.0	6.0
2001:2	1.2	210.3	5.1	5.8
2001:3	1.0	212.3	3.9	4.9
2001:4	0.6	213.7	2.6	4.1

Annual inflation rate (%)

Year	*Year on year*	*Within year*
1996	2.3	2.0
1997	1.8	2.2
1998	1.7	1.3
1999	3.4	5.8
2000	5.8	5.6
2001	5.2	3.8

Shaded area indicates forecast.

in assumptions are a somewhat lower degree of wage drift this year, or 2% instead of 2½%, caused by the fact that wage drift still measured less than 2% during the first half of the year. Productivity assumptions for this year have been raised to 2.7% in light of the most recent estimates by the National Economic Institute. These changes offset the lower exchange rate to some extent.

As usual this inflation forecast is subject to considerable uncertainty. Inflation may conceivably be higher if domestic expansionary forces continue on the scale experienced in recent months and/or the króna depreciates further. At present, however, there is fortunately more likelihood of a lower rate of inflation than a higher one. In this context it can be pointed out that petrol prices have dropped sharply in world markets recently, which should soon be transmitted to domestic prices, other things being equal. Also, the rise in housing prices could slow down in the near future on account of higher interest rates, less growth in real disposable income and poorer economic prospects. Nonetheless, the most recent measurements covering the period until June suggest that housing prices in the Greater Reykjavík Area have continued to rise.

Still no clear signs that the economy is beginning to cool

Economic statistics which are available for the first half of the year do not contain any categorical signs that the economy is beginning to cool down, and in terms of some criteria the rate of expansion is actually increasing, especially in the labour market.

Table II presents the main indicators in this respect. It shows that the real year-on-year increase in imports during the first five months of the year was greater than during the same period in 1999, since imports at fixed prices, excluding vessels and aircraft, began to rise again this year after remaining virtually stable since late summer in 1999. Imports of consumer goods are in fact growing at a slower rate than at the same time last year because of significantly lower imports of motor vehicles. Growth rates of imports of other consumer goods, however, are higher. Turnover figures based on VAT receipts are only available for the first two months of the year, and show a considerable increase in turnover in real terms, although admittedly less than last year. However, turnover in manufacturing industries excluding fish processing and power-intensive industries, and in the retail sector, has been growing at a faster rate. Compared with the year before, debit and credit card turnover growth has slowed down from just over 15% in real terms in the spring to 6% now. Even though the rate of growth is unquestionably slower now, it is nonetheless above the threshold at which excess demand is maintained.

Figures from the labour market give a categorical indication of greater tension than last year, with less unemployment and more vacant positions registered at job agencies. An increase in the number of work permits issued to foreign workers compared with last year's figure serves to relieve the tension somewhat, but at the same time bears witness to high labour demand.

Monetary and credit aggregates present a some-

Table II Selected indicators

First semester unless otherwise stated

	1999	2000
I. Turnover and demand – % increase over previous year		
General merchandise imports[1]	2.3	7.9
without fuel and metal smelters[1]	1.6	7.2
Imports of consumer goods[1]	13.2	4.6
without automobiles[1]	7.5	10.4
Merchancise exports[1]	14.2	-4.1
Turnover based on VAT-records[2]	7.7	5.9
manufacturing excl. fish and metal smelters[2]	4.3	5.5
retail trading[2]	3.2	5.2
II. Labour market		
Unemployment – % of labour force	2.2	1.6
Work permits granted to foreigners	1,193	1,472
Registered vacancies – average	149	394
III. Money and credit		
M3 – 12 month % increase[3]	20.2	12.1
M3 – 6 month % increase	12.1	7.4
Lending by deposit banks[3] – 12 mo. % increase	32.4[7]	26.0[7]
Lending by deposit banks – 6 mo. % increase	12.7	16.7[7]
Total credit[4] – 12 mo. % increase	15.8	16.8
IV. Asset prices – % increase in 6 months through June		
Equities – ISE Main list[5]	8.6	1.5
Residential real estate, Greater Reykjavík area[6]	11.1	9.1
corrected for consumer prices[6]	8.9	6.4

1. January -May at constant prices. 2. January-February at constant prices. 3. Through June. 4. Through March. 5. 6 months through June. 6. 4th quarter 1999 through 2nd quarter 2000. 7. Adjusted for mergers.

what mixed picture. On the one hand, a considerable reduction has taken place in the growth rate of the broad money supply, but on the other hand, credit growth is still far in excess of what is compatible with stability and low inflation, and measured by some criteria it is greater than last year. During the first half of the year real estate prices have risen considerably, although by less than last year. The share price index has only shown a small rise.

First-half fiscal performance supports this conclusion

Treasury revenues during the first six months of the year amounted to 100.7 b.kr. and outlays 90.1 b.kr., leaving a surplus of 10.6 b.kr. During the first half of 1999 revenues amounted to just over 90½ b.kr., outlays 82 b.kr. and the surplus 8½ b.kr. Leaving aside interest payments, a part of which are delayed payments on expenditures in previous years, the improvement is considerably greater, at over 4 b.kr. between the years. First-half treasury revenues were 11.2% higher than during the corresponding period in 1999. This is an increase of just over 5% over and above the rise in wages and prices. Excluding proceeds from the sale of treasury assets the nominal rise in revenues so far this year has been 11.4%, while the budget assumed a 4.5% rise between 1999 and 2000. Above all it is revenues from direct taxes which are rising more than had been forecast, yielding 19% more than during the same period last year. The rise between the years was estimated 5½% in the budget. Turnover taxes and other indirect taxes have now yielded 8.8% more than during the first half of 1999, while the estimated annual increase was 5.4%. Treasury outlays are now 10% higher than during the corresponding period last year, and 4% higher in real terms. Interest payments have risen by 30% from the first half last year, or 2.1 b.kr., almost entirely due to heavy redemption of savings bonds. Since the bulk of this interest has long been expensed by both the treasury and household savings bond owners, even though it is presented as a payment item now, it is more natural to look at the development of outlays excluding interest. These are 8% higher than during the same period last year (just over 2% above price rises), while the budget assumed a 3½% nominal rise between the years on a cash basis.

During the first six months of 2000, net collection of loans and short-term receivables has been around 3 b.kr., as against a 4 b.kr. outflow during the corresponding period of 1999. The main factor at work is that a considerable amount of payments for shares in state enterprises sold during the last months of 1999 did not fall due until this year. Against this inflow, the treasury has repaid 3 b.kr. of its imputed debt with the state employees' pension fund, compared with 1.3 b.kr. at the same time last year. This is totally new, because until now the treasury's pension liabilities have mounted up without any payment or formal documentation of this debt being made. In spite of these payments the above items are in balance, and the surplus on operations and net lending is equal to

Table III Treasury finances overview

B.kr.	Budget[1] 1999	Budget[1] 2000	January-June[2] 1997	January-June[2] 1998[4]	January-June[2] 1999	January-June[2] 2000
Revenues	184.8	209.9	64.1	79.3	90.6	100.7
Expenditures	182.4	193.2	66.9	75.7	81.9	90.1
Fiscal balance	2.4	16.7	-2.8	3.6	8.6	10.6
Net lending and equity[3]	14.2	4.2	-2.6	2.3	-4.2	0.0
Net borrowing requirement	-16.7	-21.0	5.4	-5.9	-4.4	-10.7
Domestic borrowing, net	-8.5	-12.1	13.7	6.3	-8.9	-9.6
External borrowing, net	-15.3	-10.4	-2.2	-5.4	-0.5	-1.4
Cash balance	-7.1	-1.5	6.1	6.9	-5.0	-0.4
Treasury securities at Central bank	0.0	0.0	0.9	0.3	1.3	2.5
Treasury securities of other sectors	-8.5	-12.1	12.9	6.0	-10.2	-12.1

1. Accruals basis. 2. Cash basis. 3. Inflows net of outflows. Extraordinary payments to state pension funds included. 4. Large increases in revenues and expenditures between 1997 and 1998 are in part due to changes in accounting practices.

the financial balance, at 10.7 billion versus 4.4 b.kr. at the same time in 1999. If the pension fund payment is simply regarded as debt amortization, the surplus before borrowing is 13.7 b.kr. now, compared with 5.7 b.kr. during the same period last year.

The treasury's scope for repaying foreign loans has been somewhat restricted by the Central Bank's foreign exchange reserve and the foreign exchange market situation. Long-term amortization has therefore been targeted especially at domestic debt, with repayments amounting to almost 10 b.kr. during the year. Foreign debt has been repaid to the tune of 1½ b.kr. and T-bills held steady. During the first half of last year, domestic loans of 10 b.kr. were repaid. The deposits of treasury with the Central Bank were virtually the same at the end of June as at the beginning of the year in contrast with the first half of last year, when they fell.

Treasury receipts of taxes on wages and spending provide considerable indications about income developments and the economic cycle. Data currently available do not reveal any substantial reduction in the growth of earnings, although there are certain signs of a slow-down in the growth of household expenditure, on the domestic front at least. Personal income tax receipts were just over 14% higher in króna terms over the period from March to June (largely reflecting personal income from February to May) than during the same period last year. At work there is a combination of rising earnings and their interaction with the limits of the personal tax-free allowance. Over this period the wage index compiled by Statistics Iceland has risen by 6-7%, but the tax-free limit by 5%. Furthermore, the number of wage earners has increased. VAT receipts during the first

Table IV Treasury revenues in first semester 1997-2000

Increase from prev. year, %	1997	1998	1999	2000
Nominal growth				
Personal income tax[1]	-8.6	15.1	12.7	14.5
Value added tax	4.7	16.9	10.7	12.5
Taxes on spirits, cars, petrol, imports and production	-0.7	16.1	5.3	2.4
Payroll taxes	9.4	12.7	9.3	9.4
Total revenues[2]	-0.9	23.8	14.2	11.2
Real growth (vis-a-vis consumer price index)				
Personal income tax[1]	-10.2	12.6	10.8	8.2
Value added tax	2.9	14.4	8.5	6.4
Taxes on spirits, cars, petrol, imports and production	-2.5	13.6	3.5	-3.2
Payroll taxes	7.3	10.4	7.5	3.4
Total revenues[2]	-2.7	21.1	12.3	5.2

1. 1997 figures adjusted to fit subsequent accounting changes. 2. Changes between 1997 and 1998 are misleading because of changes in accounting practices.

half of the year are just over 12% higher in króna terms than during the same period last year. The twelve month rate of growth of VAT-revenues peaked in the early months of 1998, dropped slightly in the second half of 1998, but levelled off in mid-1999. After adjustment for price changes, however, it is clear that the second wave was largely caused by inflation. The real growth in VAT receipts between the years is now around 6%, but was almost 9% at the same time last year. On the whole, these figures suggest that turnover is increasing at a lower rate than last year, although still not sufficiently to warrant explicit claims that the economy is cooling, which would demand a growth rate lower than the growth of potential output.

Outlook for lower growth next year than previously ...

At the beginning of June the Marine Research Institute proposed a cut in the total allowable catches (TAC) of cod and other species during the next fishing year. Measured in cod equivalents, the proposed cutback amounted to almost 18%, excluding capelin. In mid-June the Minister of Fisheries announced a TAC decision entailing a somewhat smaller cutback, which corresponds to a 4-5% contraction between fishing years. This decision has inevitably brought down economic growth forecasts, in particular next year, given that marine production is expected to remain constant this year and then contract by 7% in 2001. Coupled with this is the expected reduction in investment next year. Also, a much smaller increase in disposable income this year and next year than has been the case in the past few years, the recent rise in long-term interest rates and the drop in share prices may be expected to contribute to lower private consumption and investment next year.

Against this background and the developments in recent months, the National Economic Institute (NEI) has reviewed its economic outlook for the current year and produced its first national economic forecast for 2001, which is shown in Table V. This year, the main changes from the NEI's March forecast involve lower exports and higher imports, primarily as a result of greater investment. The consequence will be slightly lower economic growth at 3.7%, and a forecast increase in the current account deficit to 55 b.kr., the equivalent of 7.8% of GDP.

Table V Economic prospects 2000 and 2001

Annual volume changes in % if not indicated otherwise	*NEI's forecast in June 2000*		*Difference from forecast for 2000*	
	2000	*2001*	*Oct. 1999*	*March 2000*
Private consumption	4.0	2.0	1.5	0.0
Public consumption	3.5	2.5	1.0	0.0
Gross fixed investment	10.5	-3.5	8.4	2.1
National expenditure	5.1	1.0	2.7	0.4
Exports of goods and services	0.9	-1.1	-1.7	-0.9
Imports of goods and services	4.7	-2.0	2.7	0.6
Gross domestic product	3.7	1.6	1.0	-0.2
National income	3.7	1.2	1.0	-0.3
Current account balance, % of GDP	-7.8	-7.2	-3.6	-0.6
Current account balance, in b.kr.	-54.7	-53.8	-25.8	-4.2

Source: National Economic Institute.

Economic growth will contract sharply next year according to the NEI forecast. The reasons are the abovementioned quota cutbacks, significantly lower growth in private consumption than in recent years, and a contraction in investment. Thus the NEI forecasts growth of only 1½% next year. If this forecast holds good, the overheating which has prevailed in recent times will abate sharply. This in turn will produce much less growth in labour demand than has been witnessed recently. Thus there will be some increase in unemployment, which is probably now below the long-term level compatible with low inflation and economic stability given the present labour market framework. On the other hand, the current account deficit will only drop slightly, since exports are forecast to contract by more than 1%. Thus the current account deficit will remain above 7% of GDP and, all things being equal, there is no prospect of it dropping over the next few years. The Central Bank's analysis published in the May Monetary Bulletin, arguing for the need to take action to narrow the current account deficit, therefore remains unchanged.

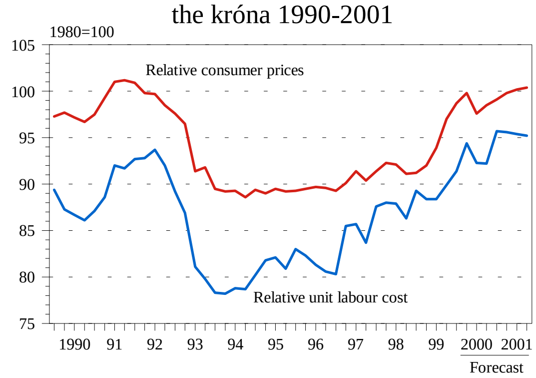
... and the equilibrium exchange rate fell

The bleaker prospects for exports, current account balance and economic growth inevitably lower the equilibrium exchange rate of the króna. This in turn has an impact on the market exchange rate of the króna if no counteraction is taken to encourage it to appreciate, such as a credible rise in the interest differential vis-à-vis abroad. Downward pressure on the króna could therefore be expected following the Marine Research Institute proposals, the Minister of Fisheries' quota decision and the new national economic forecast.

The króna had fallen by almost 4½% on July 21 compared with the end of May, and would have depreciated even further had the Central Bank not raised its policy rate by half a percentage point on June 19 and intervened heavily in the foreign exchange market on the days when pressure on the króna was at its greatest (see further the article on Financial markets and Central Bank measures). Assuming that the exchange rate remains stable, this development creates the prospect of a lower real exchange rate of the króna in the near future than had previously been assumed. However, the real exchange rate will continue to appreciate, as shown in the accompanying chart, and is expected to be 11% higher next year relative to wages than the average during the 1990s, and will then be well above the real exchange rate which prevailed before the devaluations in 1992 and 1993. Nonetheless, it will still be considerably lower than during the overheating in 1987 and 1988, cf. Chart 28 on page 60 in the Appendix.

Chart 3

Quarterly real effective exchange rate of the króna 1990-2001



The economy could begin to cool during the coming months …

There are various signs that the economy could begin to cool during the coming months, bringing domestic demand growth down below long-term growth in production capacity. Next year's economic growth prospects are one such indication. It is also likely that this year's rises in long-term interest rates will dampen demand pressures. If the rate of growth in property prices slows down significantly, this will compound the impact of the fall in share prices in recent weeks. The wealth effect that probably stimulated private consumption growth last year could then turn into the opposite effect in the near future. Naturally the depreciation of the króna will lead to greater inflation for a while, but will contribute to a decline in imports. Higher inflation will hit real disposable income if wages remain unchanged, thus bringing down private consumption.

Finally it should be pointed out that the economic and financial events of recent weeks are likely to dampen the general optimism about the economic prospects which has been driving private consumption and reducing savings recently. In fact, household savings could conceivably be starting to increase again. The fairly small increase in household debt with the credit system in the first quarter, or 1.3%, inspires certain hopes that this is happening. Admittedly the rate of increase in debt is the same as during the same period last year, but afterwards the increase in debt then jumped sharply to stand at 20% for the year as a whole. Lending figures from the banks give no signs yet that this pattern is repeating itself. Estimates suggest that higher indebtedness of households has increased their payments burden considerably over the past three years. Other things being equal, this trend will encourage lower debt accumulation and increased saving in the course of time.

… which could lead to a slowdown in inflation

All things being equal the depreciation of the króna by 4%-5% in recent weeks will cause greater inflation this year than was forecast in May. However, this rise will be temporary provided it does not prompt wage increases. If the economy then begins to cool, this will contribute to a lower rate of domestic inflation which would then offset the rise in imported inflation for a while. Nonetheless, inflation will decelerate at a slower pace than previously assumed, and according to the Central Bank's current forecast for price developments in 2001, the 12-

month rate will measure over 5½% until the spring. If this turns out to be the case, it will create uncertainty about wage developments, because of assumptions made in wage agreements that inflation should drop during the contract period. Inflation could also conceivably come down faster, as has been discussed. But given the risk posed by trigger clauses in the wage agreements, it is vital to seek out all possible ways to reduce inflation in the coming months.

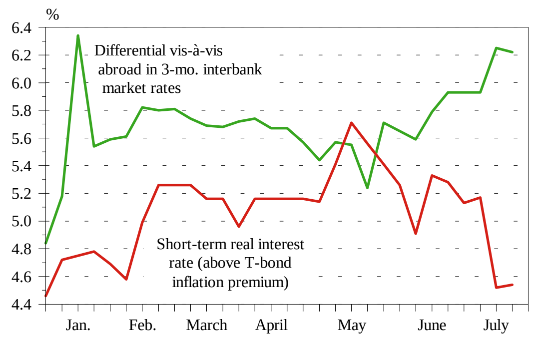
Assuming that the exchange rate remains unchanged, the Central Bank forecasts inflation of just over 5½% between 2000 and 2001 and just under 4% in the course of the year 2001. The Bank's predictions suggest that inflation could drop to 2½% during the two years following that, as a result of falling demand pressure as economic growth temporarily dips below the long-term growth of production capacity in the economy, and also due to a slight increase in unemployment and easing of tension in the labour market. The underlying assumption is that the króna will not be significantly weaker than at present. In this respect the large and persistent current account deficit represents a major risk factor. Thus the need remains for measures to boost national saving and reduce domestic demand at an even faster rate than is currently envisaged. It is important to keep these considerations firmly in mind when the coming budget is drawn up.

Monetary policy will continue to be restrictive …

For as long as inflation prospects and expectations remain far above the acceptable long-term level, significant signs of overheating still remain and credit expansion is excessive, there are clearly no grounds for relaxing the monetary stance. Measured by the short-term interest rate differential with abroad, which was more than 6% on July 21, the degree of restraint has rarely been greater. On the other hand, inflationary expectations have increased, so that the same nominal interest rate differential does not imply the same degree of restraint as before. Measured by other criteria the monetary stance has eased slightly in recent weeks because of higher inflationary expectations and the fall in the króna. Thus real interest rates in Central Bank repos have come back down to a similar level to the New Year, as shown in chart 4.

Chart 4

Short-term real Central Bank interest rate and interest rate differential vis-à-vis abroad 2000



… but remain on the alert for turning points

As outlined above, great uncertainty surrounds the extent and speed of the cool-down in the economy in the coming months. In shaping its monetary policy measures in the near future, the Central Bank will therefore be on the alert to turning points in developments. Monetary policy will aim to bring inflation down to a similar level to that among main trading partners one or two years hence. The way that the main indicators develop over the coming months will shed further light on whether it may prove necessary to tighten the monetary stance even further 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.