

## *Introduction*

# Poorer inflation outlook and depreciation of the króna impede further easing of the monetary stance

On March 27, the government of Iceland and the Central Bank of Iceland made a joint declaration announcing a sweeping reform of the monetary policy framework. The exchange rate band was abolished. Instead, the Central Bank's target is to bring inflation as close as possible to 2½%, although higher inflation is tolerated during a period of adjustment. At the same time, the government declared that the Central Bank would be granted full independence to apply its instruments in order to achieve this target, and announced that a parliamentary bill would be proposed with the aim of incorporating these reforms into law.

The declaration by the government and the Central Bank is published in its entirety in this Monetary Bulletin, together with a separate article explaining the reforms in more detail. In the last Monetary Bulletin, the Bank stated its view that there were many arguments in favour of this reform. In fact, it had been preparing such action for some time, and more intensively after the exchange rate band was widened to ±9% in February last year. The Bank had become convinced about the extreme difficulty of maintaining the exchange rate within specified limits in an environment of unrestricted capital flows, in addition to which Iceland's economic structure is more suited to a flexible exchange rate than a fixed one. However, the timing of the reform was set to coincide with the planned announcement of a new draft Central Bank Act at its annual meeting. This would have fuelled expectations of a pending systemic reform which could conceivably have put unwarranted pressure on the exchange rate, since the

draft act contained clear authorisation to adopt inflation targeting.

The Central Bank announced on March 27 that it had lowered its policy rate for repurchase agreements with credit institutions by half a percentage point. Interest rates were lowered in light of the fact that the Bank's February inflation forecast was consistent with the newly set inflation target. Admittedly the króna had depreciated somewhat since that forecast was made, but the Bank did not consider the depreciation to be warranted by fundamentals. The depreciation primarily seemed to be linked to uncertainties about the pending policy framework reform. Thus the weakening was expected to be reversed to some extent in the course of the year. Arguments in favour were that the inflation rate in February and March had measured less than the Bank had forecast, and inflation expectations had come down. In addition, the first signs of a cooling in the economy had appeared, especially in figures for turnover and imports, and the National Economic Institute had recently forecast a substantial slowdown in growth of domestic demand and GDP. Finally, in the Bank's view the monetary policy stance was very tight. The Bank was concerned that such a tight stance would lead to a harder landing than the inflation target required. In spite of the cut in interest rates, the monetary stance remains tight.

The Central Bank left its overnight lending rates unchanged when the repo yield was lowered, in order to reduce the use of overnight lending facilities and to stimulate the interbank market. In recent weeks, however, liquidity has tightened in the domestic

money market, taking the form of considerably higher REIBOR 14-day rates than those for Central Bank repos, and higher overnight lending rates in the domestic interbank market than those set by the Central Bank. All things being equal, an increase in the outstanding balance of Central Bank repo agreements increases liquidity. However, this has been offset by the Central Bank's intervention in the foreign exchange market, which until the end of March reduced the supply of domestic currency. Moreover, the liquidity position of the treasury has been good. Base money has therefore not increased. The Central Bank does not see a need for any particular measures on its part in order to counter this lack of liquidity, and is of the view that credit institutions can deal with it themselves by reducing their lending and taking advantage of available options for short-term borrowing.

Exchange rate and price developments have been unfavourable since the monetary policy framework was changed and the interest rate cut towards the end of March. While inflation in the first quarter turned out as the Central Bank had forecast, subsequent developments have been less benign. The exchange rate depreciated by more than 5% from March 27 to April 26, the CPI in April rose far in excess of what market participants had expected and inflation expectations have been increasing again as a result. The near-term inflation outlook has therefore deteriorated. The Central Bank now forecasts that inflation could reach as much as 6% during the second half of this year and will be 5.7% over the year. Subsequently, inflation should begin to slow down as the economy becomes less overheated. This is based on the assumptions that the depreciation in recent days will prove short-lived and current wage agreements are not disrupted. If this holds good, the Central Bank's newly set inflation targets will be achieved around the middle of 2003, although early next year inflation could conceivably exceed the tolerance limits temporarily.

A report on financial stability is included in this Monetary Bulletin. It reveals that credit expansion in recent times, and the excessive current account

deficit which has occasioned a considerable currency depreciation in the past few months, pose a risk to financial stability, as the Central Bank has warned before. At the same time, the financial system's capacity for withstanding tougher conditions has diminished in various respects, manifested in poorer profitability and lower capital ratios. The nature of financial crises is that they can strike without unmistakable warning signs, as has happened among Iceland's neighbours and around the world. Numerous international studies have revealed various probable, although not certain, leading indications of financial crises. Some of them, e.g. a current account deficit, credit expansion and real estate price inflation, which have been linked to financial crises in other countries, have provided firmer warning signs than before. In the absence of further external shocks, however, the position of Iceland's credit institutions is hardly at risk.

The Central Bank does not identify any long-term economic justification for the depreciation of the króna that has taken place, which is also undesirable from the perspective of its inflation target. The large depreciation of the króna in recent days is, in the Bank's opinion, a temporary phenomenon which is explained among other things by more sluggish funding of the current account deficit, the fishermen's strike and the tendency of foreign exchange markets to overshoot. An excessive current account deficit clearly undermines the exchange rate in the long term, even if the exchange rate is not its root cause, and can thereby jeopardise price stability.

The monetary stance is still very tight. Clearer signs are also emerging that the economy is cooling down. A poorer inflation outlook and pressure on the exchange rate, however, will impede a further lowering of interest rates for the time being, even though less economic activity may warrant this. Thus there is a greater likelihood that a monetary policy aimed at conquering inflation will cause a temporary contraction. The newly set inflation target will eventually be achieved, however, despite a temporary burst of inflation and a harder landing than was previously hoped for.