

Introduction

To be successful, monetary policy must be forward-looking

Inflation targeting implies that monetary authorities seek to be forward-looking when deciding on policy, rather than responding to current or past conditions. The Central Bank's rises in its policy interest rate amounting to almost 4 percentage points over one year were a response to foreseeable inflationary pressures two years ahead rather than inflation over the preceding year, although the two are certainly connected.

Inflation slowed down in April and May after climbing sharply in the opening months of the year. Measured by the Harmonised Index of Consumer Prices for the European Economic Area (EEA), inflation in Iceland in April was below the average in EEA countries. Excluding the housing component of the index, the price level in May was unchanged year-on-year and merchandise prices had gone down. Thus it is natural to ask whether a tighter monetary stance is necessary.

There is a high probability that the slowdown in inflation over the past two months will be short-lived. Inflation will probably pick up when the impact of the appreciation of the króna since December 2004 and changed method for calculating average mortgage interest cost in the housing component of the CPI have petered out and exceptionally fierce price competition in the supermarket sector has waned.

The exchange rate of the króna on which the inflation forecast in this edition of *Monetary Bulletin* is based is 6% weaker than in the forecast published in the previous *Monetary Bulletin* in March. As it happens, the króna strengthened after the current forecast was made, but not by enough to alter the Bank's assessment of economic prospects to any degree. A weaker króna channels demand into the domestic economy and also directly affects consumer prices. Furthermore, private consumption may grow even faster than was forecast in March, marginally widening the output gap. The inflation outlook over the next two years has therefore deteriorated since March. On the other hand, there is less probability that the rate of inflation two years ahead will be higher than in the base forecast.

The short-term inflation outlook is broadly unchanged, i.e. inflation will slow down and approach the target early next year. One contributing factor is Statistics Iceland's changed method for calculating mortgage interest cost in the housing component of the CPI. However, this change has no effect on the Central Bank's assessment of underlying inflation. It has a minimal effect on inflation prospects two years ahead, because the base effect of the change will fade out within two years. Assuming an unchanged policy rate, the outlook is still for inflation to exceed the target in the first half of 2007, possibly at a higher rate than was forecast in March.

Although the Central Bank has to take a forward-looking approach in its interest rate decisions, its forecasts are always based on current and historical data. The reliability of such data varies and they are subject to various interpretations. Interest rate decisions can thus never be absolutely right, not even in retrospect. When the macroeconomic balance has been severely disrupted by major events such as the present build-up of the aluminium industry and structural changes in the financial system, it is impossible to fine-tune monetary policy measures closely enough to prevent volatility or temporary difficulties in the economy. The crucial consideration is for the Central Bank to apply as professional and systematic methods as possible to assess the inflation outlook, and not to lose sight of its long-term objective of price stability.

Monetary policy implementation is unusually challenging at the moment. A particular problem is that when macroeconomic imbalances occur and economic variables shift way beyond a level that seems compatible with long-term stability, the timing and speed of readjustment is crucial for subsequent developments. This applies to economic variables such as asset prices, the exchange rate and the current account deficit. However, it is extremely difficult to pinpoint when and under what conditions the inevitable adjustment will take place.

Asset prices, the strength of the króna, the current account deficit and lending growth all appear to have reached levels that are unsustainable in the long term, even after taking into account the effect of investments in the aluminium and power sectors. In the long run there appears to be a strong case for a correction of real estate prices, at least in real terms, a depreciation of the króna and a reversal of the current account deficit. Such an adjustment will have a substantial effect on output growth and inflation. The foreseeable contraction in investment may conceivably produce a widespread adjustment throughout the economy after two or three years, although it is uncertain whether this will be as rapid as some have argued. A tight monetary policy stance at present may contribute to a more gradual adjustment, by inducing a timely slowdown in economic activity. Some action apparently remains to be taken in this respect.

The Board of Governors of the Central Bank of Iceland has therefore decided to raise the Bank's policy interest rate by 0.5 percentage points as of June 7. A further tightening may be necessary in order to contain inflation, and the Central Bank will continue to monitor unfolding events closely in order to assess the need for further action.