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Report to the Government on inflation beyond the tolerance limit

The Central Bank of Iceland is currently preparing new inflation and macroeconomic forecasts which will be published in Monetary Bulletin later this month. When those forecasts are available, the Board of Governors will assess whether the monetary stance needs to be tightened further. As provided for in the Central Bank Act and the declaration on the inflation target, decisions in this area will aim to ensure that the inflation target is attained in the next two years. It is already clear that further measures are needed for this to be achieved. Fiscal constraint is crucial to such efforts and the future role of the Housing Financing Fund should also be clarified as soon as possible.

Act No. 36/2001 on the Central Bank of Iceland stipulates price stability as the main objective of monetary policy. The declaration by the Government of Iceland and Central Bank on March 27, 2001 set an inflation target for the Bank, i.e. to aim for an average rate of inflation, measured as the twelve-month increase in the CPI, of as close to 2½% as possible. The declaration grants the Central Bank full independence to apply its instruments in order to attain the inflation target. Furthermore, the declaration includes provisions for Central Bank accountability towards the government and the public. One way in which this is done is to define tolerance limits, which are currently 1½ percentage point on either side of the target. If inflation moves beyond the tolerance limit, the Bank is obliged to submit a report to the Government explaining the reasons for the deviation, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report shall be made public. However, the tolerance limits do not imply any other formal obligation for the Central Bank to respond. It should be reiterated that the objective of monetary policy is to maintain inflation as close to the 2½% target as possible, and not merely within the tolerance limits.

This September, the twelve-month increase in the CPI measured 4.8%. Inflation has therefore moved beyond the tolerance limit for the second time this year, which is the occasion for the present report. After inflation breached the tolerance limit in February, the Central Bank outlined inflation developments and the inflation outlook in a report submitted to the Government and dated February 18. Inflation developments and the inflation outlook were also discussed in the March and June editions of the Central Bank's quarterly *Monetary Bulletin*. The Bank will publish its next *Monetary Bulletin*, including a new inflation forecast, on September 29. Since publication is pending, the Central Bank does not consider that a detailed report is necessary on the present occasion. *Monetary Bulletin* will include a detailed analysis of inflation developments over recent months and the reasons that inflation has now exceeded the tolerance limit.

The Central Bank's report to the Government in February discussed the main factors that sent inflation beyond the tolerance limit, and the rapid growth of domestic demand which was driven both by investments in power stations and aluminium smelters and by unexpected structural changes in the credit market.¹ These explanations still apply. Growth in household lending, which is partly the consequence of structural changes in Icelandic financial markets, has in fact been gaining momentum in recent months and housing prices have risen at a record pace. This development is reflected in a sharp rise in the housing component of the CPI, which over the period May-August accounted for virtually all the overall rise in the index. By comparison, the housing component explained around half of the twelve-month increase in the CPI in February. The spike in the CPI in September, however, was largely the product of other factors, i.e. substantially greater-than-expected seasonal increases in goods prices when summer clearance sales came to an end. Fuel prices also soared, and services prices showed a substantial increase. This occurred in spite of the very strong króna, which led to a marked drop in goods prices during the summer, and fierce competition in the discount supermarket sector which temporarily drove prices down from the second half of the winter. Prices of consumer durables, in particular cars, do not seem to have gone down in pace with the exchange rate trend, however. Nor have petrol and oil prices tracked the exchange rate, for obvious reasons. Nonetheless, the core price indices, which exclude changes in petrol and other items, did not show a significantly smaller twelve-month increase than the total CPI in September. The explanation is that the core indices exclude not only petrol but also other volatile components – agricultural products, vegetables and fruit – and their

¹ The report was published in *Monetary Bulletin* 2005/1 in March.

prices have risen by less than the index or even fallen over the past twelve months

As in February, inflation now is primarily demand-driven, although higher petrol and oil prices make some contribution, accounting for roughly 0.6% of the twelve-month rise in the index. Demand pressures appear to have mounted and are once again most clearly reflected in the index components that are protected from international competition, i.e. housing and services prices. On the other hand, the strength of the króna has constrained inflation even though the appreciation over the past year has not yet been fully transmitted to prices. When the króna eventually weakens again this effect will unwind, conceivably accompanied by a sharp slowdown in housing inflation or even a drop in housing prices.

The Central Bank published its last inflation forecast at the beginning of June. It showed a rate of inflation above the target over the next two years. In response, the Central Bank raised its policy interest rate at the same time as the forecast was published. Furthermore, the Bank implied that it would probably need to continue on the same path. As pointed out above, economic statistics published since the beginning of June indicate that domestic demand has been picking up speed this year. Annualised private consumption in the second quarter, for example, measured 14%. The current account deficit will be probably wider than was forecast in June, housing prices have continued to rise apace and lending to both households and businesses has gained momentum. Pressures are also building up in the labour market.

The Central Bank's latest inflation and macroeconomic forecasts are now being prepared and will be published in *Monetary Bulletin* later this month. When the forecasts are at hand, the Board of Governors will assess whether the monetary stance needs to be tightened further. As provided for in the Central Bank Act and the declaration on the inflation target, decisions in this area will aim to ensure that the inflation target is attained in the next two years. It is already clear that further measures are needed for this to be achieved and a contribution from the fiscal side is necessary. The fiscal position is currently quite strong, but a tight stance is still needed next year. The tighter the fiscal stance, the less burden that has to be borne by monetary policy and the milder its negative side-effects will be. In addition, the future role of the Housing Financing Fund should be clarified as soon as possible, since much of the immoderate lending growth witnessed over the past year can be attributed to structural changes in the mortgage market.