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Monetary and financial stability in Iceland

Welcoming address at a SUERF and Central Bank of Iceland Seminar in Reykjavík, June 3, 2004[1]

On behalf of the Central Bank of Iceland, I warmly welcome you to this seminar on the *Interaction of Monetary and Financial Stability in Small Open Economies*. It is an honour for us to co-sponsor the seminar with SUERF. We are grateful to David Llewellyn, Eduard Hochreiter, Beatrix Krones and Michael Bailey at SUERF for the excellent cooperation which we have enjoyed with them in its preparation. I welcome in particular our keynote speaker, Sir Andrew Crockett.

The topic of the seminar is an appropriate one which is attracting increasing attention, both within and outside central banks. I trust that the presentations and discussions over the next two days will leave us with a better understanding of this interaction and of the issues on which we wish to focus our attention in the period ahead.

We will be assisted by very impressive speakers and participants. I wish to extend my gratitude to those who have agreed to give lectures and present papers and I look forward to inspiring and stimulating contributions by them.

In this address, I will briefly describe our own recent experience in the areas of monetary and financial stability.

The current Act on the Central Bank of Iceland was adopted in 2001[2]. It assigned to the Central Bank the main objective of pursuing price stability. The Bank was granted instrument independence to pursue that main objective, its financial independence was enhanced and the Act included clear provisions on transparency and accountability. The Act also stated that the Bank should promote an efficient and safe financial system, including payments systems domestically and with foreign countries. In addition to price stability, the Bank was, in other words, given a clear mandate to concern itself with financial stability.

An inflation targeting framework was adopted at practically the same time with a joint declaration of the Government and the Central Bank which set a target for inflation of a 2½% twelve-month rise in the CPI. The framework imposes strong demands on the professional capacity of the Central Bank. The Bank regularly publishes a macroeconomic forecast and inflation forecast, with an associated inflation report. The inflation forecast provides the foundation for the inflation targeting policy. In its quarterly *Monetary Bulletin*, the Bank publishes a detailed analysis of current economic and monetary developments and prospects. It also presents the rationale behind the decisions by the Board of Governors to change or not to change interest rates, as well as signalling the monetary policy intentions for the period ahead. In these endeavours, the Bank seeks to be as transparent as possible.

1. Welcoming address at a SUERF (The European Money and Finance Forum) and Central Bank of Iceland Seminar in Reykjavík, Iceland, on June 3, 2004.
2. See *inter alia* Central Bank of Iceland *Monetary Bulletin* 2001/3, pp. 31-46.

When the inflation target was adopted, the economy was quite unbalanced. It had boomed during the second half of the 1990s. The upturn was originally well balanced, being led by foreign direct investment and exports. But eventually it turned into overheating and a surge in private consumption, which was fuelled, among other things, by rapid credit expansion in an increasingly liberalised financial environment.

In due course, the imbalances began to have a negative effect on expectations, partly because of a sharply deteriorating current account. The currency began to slide and fell by a third in trade-weighted terms over a period of a year and a half until late 2001. This development affected inflation as rising import prices fed into domestic prices. When the inflation-targeting framework was adopted, the most recent measure of the twelve-month rise of the CPI was about 4%. The króna continued to depreciate for some time after the adoption of the target and inflation rose significantly above the upper tolerance limit of the inflation target. The Central Bank pursued a restrictive monetary policy, repeatedly raising its policy interest rate which reached a historically high level. This ultimately led to a rapid fall in inflation after January 2002 and by late that year it had fallen under the inflation target, where it has remained more or less since until the most recent measure.

We have now pursued an inflation-targeting policy for more than three years. Our view is that it has been successful. Inflation was brought under control relatively quickly after the adoption of the inflation target in very unbalanced economic circumstances. There is also firm evidence that the inflation-targeting regime has earned credibility in the markets and the community. The monetary regime will be further tested in the period ahead, which will among other things be characterised by an exceptional level of foreign direct investment in the aluminium industry and associated publicly owned and debt-financed power plants.

Our experience is a strong indication that inflation targeting is a policy which can be pursued in a very small and open economy as well as in a large economy with very deep financial markets. This policy is resource-demanding and imposes by necessity a very strong discipline on the respective central bank.

In our view the increased focus on financial stability in the Central Bank Act of 2001 was natural and well within the accepted framework of central bank activities. The Bank was responsible for banking supervision until the end of 1998 when that function was merged with the Insurance Supervisory Authority in a new and unified Financial Supervisory Authority, with which the Central Bank cooperates quite closely on financial stability issues. While the Central Bank had responsibility for banking supervision, its attention was necessarily focused on individual institutions and overseeing that their operations complied with existing laws and regulations. Before banking supervision was transferred elsewhere, the Central Bank had also begun to focus its attention on broader financial stability issues along the lines that many other central banks were doing at that time. A logical part of that process was that in 2000 the Bank began to publish semi-annual financial stability analyses in its quarterly *Monetary Bulletin*.

One reason for the increasing focus of the Bank on systemic financial stability issues in the late 1990s was the growing perception in a liberalised financial market that a weak financial system could undermine economic and monetary stability just as much as economic imbalances and weak policies could undermine an otherwise sound financial system. A sound financial system, including safe and secure payment and settlements systems, is also an important precondition for the effective implementation of monetary policy. Capital movements were fully liberalised in the 1990s, as was the domestic financial market which also underwent significant structural change, including the withdrawal of the government from direct ownership in banking institutions. These developments stiffened competition at home and linked the domestic financial system much more closely to international markets. Consequently, in its analyses, the Central Bank consistently draws attention to the potential vulnerability of the domestic financial system to changes in the external environment, including the ready availability of foreign credit for refinancing purposes, and its vulnerability to sudden changes in the exchange rate.

The developments in the Icelandic economy towards the end of last decade and into this one resembled in many ways those experienced in some of the other Nordic countries a decade earlier.

Needless to say, and in view of the experience of other Nordic countries, these developments caused considerable concern about the underlying stability of the financial system. The Central Bank candidly expressed these concerns in its financial stability reports, most notably in the spring of 2001. At that time the IMF also issued its Financial Stability Assessment which questioned the strength of the financial system in Iceland in view of the tremendous imbalances in the economy and what was perceived to be an underlying weakness in the banking institutions. The IMF identified a potential risk of a rapid depreciation of the currency, which it felt could further weaken the banks and pose a threat to them.

Early on in the upswing, amidst a rapid expansion of lending and external indebtedness of the banks, particularly their short-term foreign debt, the Central Bank imposed a liquidity requirement on the commercial banks. Its purpose was to stem the growth of foreign borrowing and to shift the weight of foreign indebtedness from the very short end of the maturity spectrum. Another prudential rule set by the Central Bank concerns the foreign exchange exposure of commercial banks. This sharply limits their scope for taking direct foreign exchange risk. Beyond these prudential regulations, the means which the Central Bank has to affect the practices of the banks are through public pressure, for example in its semi-annual financial stability reports or in other public or private statements. The Bank has used all these methods with varying degrees of success. In line with the traditional role of central banks, the Central Bank of Iceland can serve as a lender of last resort if a domestic bank experiences a liquidity shortfall. The Central Bank has also systematically built up its foreign exchange reserves in order to strengthen the external liquidity position of the economy.

As it happened, the Icelandic economy landed remarkably softly after the turbulent period of 1998 to 2001. I mentioned earlier that inflation was brought under the inflation target in late 2002. The external current account was more or less in balance in 2002 only two years after the deficit had measured 10% of GDP, credit growth came to a halt, and in stark contrast to what happened in other Nordic countries a decade earlier, the banks emerged from the period in a satisfactory position and have gained considerable strength since. No doubt there are many reasons for this relatively favourable outcome. One could mention the generally good external conditions during the adjustment period, a relatively sound fiscal policy, and the swift correction of the external imbalance, as well as the rapid turnaround in the exchange rate after it reached its trough and the decline in the rate of inflation to below the inflation target. In a follow-up to its report of 2001, the IMF recognised in mid-2003 the successful adjustment of the Icelandic economy, the significantly increased strength of the financial system and important changes in the regulatory framework.

The principal objective of the monetary policy of the Central Bank of Iceland is price stability, as I mentioned earlier. Its other principal goal is financial stability. The financial stability analyses focus on macroeconomic stability factors and on the strength and soundness of the financial system as a whole. The Bank addresses both these principal areas with a strong professional ambition. Its two main fields of analysis reinforce each other and benefit from close cooperation among the staff. Both areas have forced us to put our analyses, projections and policies on a longer-term perspective which provides an opportunity for better overall economic and monetary policy management.

Although much remains to be explained about the nature of the interaction of monetary and financial stability, I mentioned earlier that a sound financial system is a precondition for economic and monetary stability and the implementation of an effective monetary policy, and that economic imbalances and weak policies could undermine an otherwise sound financial system. In this respect, these areas support each other. Since financial liberalisation was introduced, we have not faced circumstances where financial stability concerns have directly affected or conflicted with monetary policy decisions. Our aim is to prevent such a situation from arising. The potential risks to financial stability at the end of the last upswing were defused by the swift achievement of monetary stability and the restoration of internal and external balance.

In conclusion, I would like to repeat my warm welcome to all the participants in the seminar. I trust that both the seminar and your stay in Iceland will be interesting and rewarding, professionally and socially.