BIRGIR ÍSL. GUNNARSSON

Governor and Chairman of the Board of Governors, Central Bank of Iceland

Address to the Annual Meeting, March 26, 2002[1]

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 41st annual meeting. The Bank's financial statements for the year 2001 have been ratified today by the Prime Minister. The Bank's annual report has also been published. As usual it includes a survey of the Bank's activities and performance, along with a detailed report on the Bank's monetary policy and activities, the financial system, financial stability and the financial markets, and the main features of economic developments in the course of last year. I shall now address several highlights of economic issues last year and the present prospects, from the Central Bank's viewpoint.

New Central Bank Act

The year 2001 was an eventful one in the history of the Central Bank of Iceland. Parliament passed new legislation on the Bank, about which a strong parliamentary consensus prevailed. Previously, fundamental changes had been made to the foundations of monetary policy and announced at the Bank's annual meeting a year ago. The new legislation consolidates the new monetary policy framework. I shall now discuss these two major issues in more detail.

The new Central Bank Act replaced the Act of 1986, which was obsolete in various respects and out of touch with developments in most industrial nations. The new Act simplifies and clarifies the Bank's objectives. It sets comparable objectives for the Central Bank of Iceland to those by which central banks operate in Iceland's main trading partner countries. Price stability is made the main objective of monetary policy. The Central Bank shall also work towards other objectives, such as an efficient and safe financial system. The Bank shall contribute to the furtherance of the government's policy, provided it does not consider this to be inconsistent with the main objective of price stability. The new legislation grants the Central Bank much more independence than before. Nonetheless, the ultimate monetary policy objective, i.e. the numerical value of the inflation target, is determined jointly by the government and the Central Bank.

The Bank is now ensured full independence to apply its instruments towards attaining the inflation target, which is probably the most important change in the law. Comparable provisions are in effect for central banks in the overwhelming majority of industrial nations. Likewise the law embodies clearer provisions on the Bank's transparency and accountability towards the government and the general public. Thus the long-term objective of monetary policy is formally established, while open and effective implementation of monetary policy is ensured at the same time.

The Central Bank's independence is also reinforced insofar as the new act states that direct treasury funding in the Central Bank is not allowed. Earlier legislation did not preclude this access, although an agreement was in effect between the Finance Minister and the Bank, originally made in

1. Translated from Icelandic.

1992, that the Treasury would not take advantage of this authorisation. The Bank's financial independence was also increased by provisions for strengthening its capital. The entry into effect of the new Central Bank Act can be said to have brought the most crucial factors for implementation of independent monetary policy broadly into line with best practices elsewhere.

Inflation target

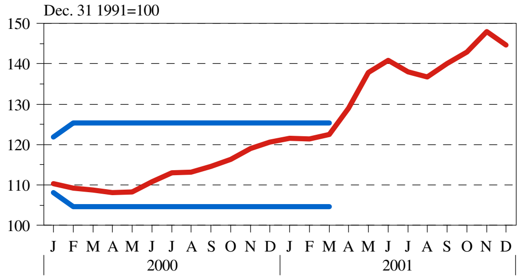
A turning point was reached in the history of Iceland's exchange rate framework and monetary policy implementation when a formal inflation target was adopted and the regime which had used exchange rate stability as an intermediate aim and the anchor for monetary policy was abandoned. Exchange rate stability had been the backbone of monetary policy in one form or another virtually ever since the króna came into existence as an independent currency, although the degree of flexibility was sometimes so great that it was tantamount to a floating regime.

There was some buildup to the decision to implement inflation targeting. It was clear that, under certain circumstances, the deregulation of capital movements around the middle of the last decade complicated successful monetary policy implementation on the basis of a stable exchange rate. Difficulties in monetary policy implementation also transpired in 1999 and 2000. Exchange rate policy by then apparently presented an obstacle to the Central Bank's main objective of maintaining price stability. Then the exchange rate of the króna began to weaken in 2000 despite active intervention by the Central Bank in the foreign exchange market. In the first quarter of 2001 the Bank's foreign position was weak, no end was in sight to the currency outflow and the exchange rate of the króna was close to the lower target band of exchange rate policy, which allowed a 9% deviation in either direction from the central value of the official exchange rate index. By then it was fairly clear that it would be difficult to defend the target band for much longer.

Chart 1

Monthly average exchange rate index of foreign currencies vis-à-vis króna 2000-2001

Deviation bands abolished in March 2001.



Source: Central Bank of Iceland.

On March 27 the government and the Central Bank decided to follow the example of the large number of countries which in recent years have adopted inflation targeting, and the króna was floated. Preparations for conceivable reform had been under way at the Central Bank for some time, since research suggested that inflation targeting would be a more suitable regime in Iceland than a unilateral fixed exchange rate policy. It was decided with a joint declaration by the government and the Central Bank that the Bank's inflation target would be 2½% and would be attained no later than 2003. Tolerance limits were also defined, i.e. a deviation of 1½% in either direction. If inflation exceeds the tolerance limit, the Central Bank is obliged to submit a report to the government explaining the reason, assessing when the inflation target will be attained again and outlining necessary action towards this end. This report is to be made public. In light of prevailing conditions when inflation targeting was adopted, the upper tolerance limit was initially set higher, so that inflation could be as much as 6% for the rest of 2001 and 4½ % in 2002 without a special report being required from the Central Bank. The inflation target tolerance limit was broken as early as June 2001, and the Central Bank submitted a report to the government which was made public. Since then the Bank has regularly outlined price developments and prospects in its quarterly *Monetary Bulletin.*

Price developments

As I mentioned before the main objective of the Central Bank is to promote price stability. I shall now turn to price developments last year and the main factors influencing them. Inflation grew sharply during the year. The consumer price index rose by 9.4% from the beginning to the end of the year, and recorded its greatest 12-month increase since August 1990. Average annual inflation between 2000 and 2001 was 6.7%, the highest rate since 1991. Productivity, measured as the GDP growth in excess of labour force growth, went up by 2.7%, but by only 1% in 2001. The exchange rate of the króna fell by almost 15% in 2001 and almost 17% from the average annual rate of the preceding year. Above all, the weakening of the króna from mid-2000 onwards can be attributed to the wide current account deficit and heavy net outflow on indirect and direct foreign investment. The deficit was reasonably easy to fund for most of 2000, but financing turned more sluggish in the second half of the year, and in 2001 the exchange rate fell almost continuously until the end of November. By then the real exchange rate of the króna was at its lowest point for decades, and lower than the Central Bank considered compatible with economic fundamentals.

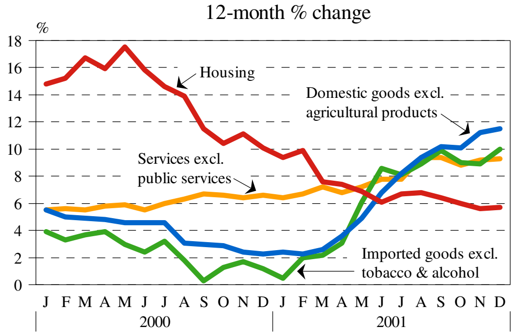
The slide of the króna unleashed inflationary pressures which had been building up in recent years. For many years wage costs rose in Iceland far in excess of productivity. Over the period 1996-2001, wages per unit of production increased by 11.5% in Iceland, but by 2.2% among trading partner countries. The strong exchange rate of the króna until 2000 had kept the inflationary impact of wage rises in check, but gave way in 2001. As can be expected, inflation grew by even more in Iceland than in main trading partner countries, where it fell on average from 2.2% from June 2001 to 1.8% in December. It is often pointed out that sectors of the Icelandic economy which are competing with those in other countries cannot sustain a wide interest rate differential in the long run. This is certainly true, since a high rate of interest is only intended to remain in effect for the time needed to restore satisfactory balance. On the other hand, it is equally clear that competing sectors in Iceland cannot sustain a rate of inflation many times higher than among trading partner countries for years on end either. Thus it is an urgent economic task to bring inflation down to the rate prevailing in the countries with which Iceland competes.

A wide range of signals that the economy was overheating emerged in 2001. Pressure in the labour market remained strong right until the end of the year. Unemployment averaged only 1.3%, but entered an upward trend in the last months of the year. Labour market pressures also took the form of growing wage drift. From the fourth quarter of 2000 to the same period in 2001, wages in the private sec-

Chart 2

The consumer price index by origin 2000-2001

12-month % change

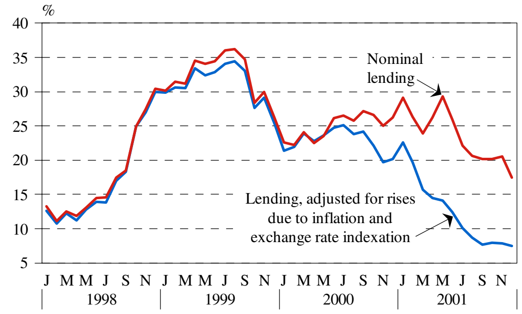


Source: Statistics Iceland.

Chart 3

Bank lending 1998-2001

12-month % change



Source: Central Bank of Iceland.

tor, other than financial institutions, increased by almost 3½% in excess of contractual wage rises, while wage drift in previous years had largely been in the range 1.2-2%. In the closing months of the year, however, signs could be seen that wage drift was decreasing. Public sector wage rises also continued to outstrip those of other groups, and new agreements with several groups of civil servants led to considerable increases.

Strong economic growth

Following three years of excessive credit growth, lending decreased in 2001. After adjustment for the weakening of the króna, and excluding indexation adjustments, lending by deposit money banks increased by 7½% last year, compared with 20% the year before. Lending by the credit system as a whole grew by more, however, in particular as a result of greater lending for housing purchases.

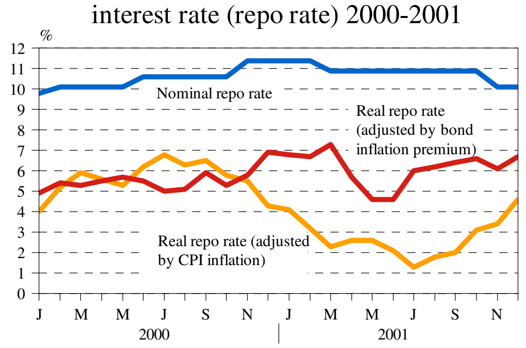
For most of last year the Central Bank came under strong pressure to lower interest rates by more than it actually did. The policy rate was lowered by 0.5 percentage points in March and 0.8 percentage points in November. In the debate on this issue, the Central Bank heard claims that the economic downturn, as it was called, would soon give way to a major contraction and even a depression, and that businesses were struggling for survival. All this turned out to be highly exaggerated. Economic growth ran high last year although it fell short of the record years, and is now estimated to have been 3%. By comparison, economic growth in the euro region is estimated at 1.5% and among the world's largest industrial countries at 1%. Growth in Iceland in 2001 therefore ran higher than in most industrial countries in the world. Also, growth in 2000 turned out to be much greater than was initially thought last year, or 5½% according to most recent statistics. The output gap, i.e. economic growth in excess of production capacity, was therefore much greater than earlier forecasts had suggested. This pressure played its part in last year's inflation developments. It also means that the output gap has prevailed for longer than was originally thought.

However, the economy began to cool down, affecting some sectors more than others. There was a substantial drop in imports of consumer durables such as motor vehicles, media advertising revenues shrank and demand for industrial premises fell, to cite a few examples. This does not alter the fact that a tight monetary stance was still needed to foster economic balance and close the large output gap that prevailed in Iceland last year. There is no question that the tight monetary stance contributed to cooling down the economy and at the same time paved the way for a rapid reversal of the inflation that the weakening króna had fuelled.

One of the main ways in which the Central Bank implements its monetary policy is by controlling interest rates in the money market, in particular by determining the yield on its repo transactions with credit institutions. Money market yields have a strong effect on currency flows and thereby on the exchange rate, and in the long run on domestic demand. In a small and open economy, the exchange rate is important for domestic price developments and the business climate in general. Interest rate changes therefore impact inflation both in the short and the long term: in the short term through the exchange rate of the króna which is sensitive to interest rate changes, and in the long term by affecting demand and the output gap. Studies by the Central Bank suggest that interest rates in Iceland have a

Chart 4

The Central Bank repurchase agreements interest rate (repo rate) 2000-2001



Source: Central Bank of Iceland.

similar impact on inflation in the long run to those in other industrial countries. High rates of interest are therefore not inflationary in character: they reduce inflation. Central banks in large economies such as the USA and EU do not need to pay much attention to the exchange rate, although they sometimes do so nominally. The reason is that these economic entities are to a large exchange self-sufficient and exchange rates have a negligible effect on their inflation rates. The Central Bank of Iceland, on the other hand, cannot allow itself to ignore exchange rate trends, given how much they affect prices. The Central Bank's reluctance to cut interest rates in the past few months is not least connected to anxiety about the exchange rate trend. Although studies indicate that the exchange rate may strengthen from the beginning to the end of this year, the experience of recent weeks also shows that it is susceptible to external events and has shown some swings in very recent weeks. Agreements between employers and unions on a review clause of wage contracts not being triggered if inflation is below a certain level in May caused such short-term perspectives to carry more weight in the Central Bank's standpoint than they normally would. The Bank has regarded it as extremely important to contribute to keeping inflation below this trigger level. It is also clear that the curve of economic overheating and pressures rose higher than had previously been thought and has fallen more slowly and by less than had been expected.

Inflation prospects

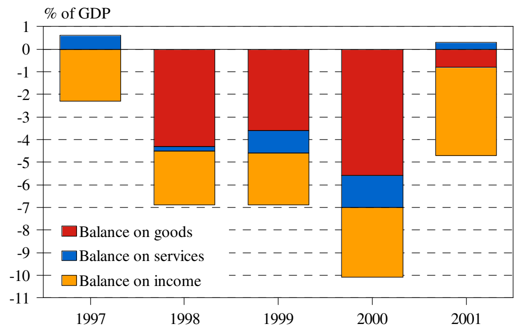
Next I shall turn to inflation prospects. The Central Bank publishes an inflation forecast four times a year, projecting two years into the future. The last inflation forecast was made at the beginning of February, based on assumptions as of January 21. That forecast assumes a fairly rapid slowdown in inflation this year, which could reach 3% from the beginning to the end of the year. Inflation is expected to drop below the 4% tolerance limit in August. A 3% inflation rate is forecast for 2003 and the first quarter of 2004. Price measurements which have been published since then confirm that inflation is decelerating. Over the past 12 months inflation has measured 8.7%, but over the past three months the annualised, cyclically adjusted rate has been 4.7%.

Specific assumptions underlie all forecasts. Hitherto the Central Bank has assumed an unchanged exchange rate in its inflation forecasts. Last year's large exchange rate decreases upset the Bank's inflation forecasts somewhat and inflation has not come down as quickly as the Bank assumed. Now the exchange trend has reversed, with all the more likelihood that the latest inflation forecast will hold good. The fact that the króna has strengthened by 2.32% since the forecast was made increases the probability that the 2½% inflation target will be attained in 2003.

I mentioned earlier that the overheating which has prevailed in the economy for some time has begun to wane. The economy is unquestionably heading for better balance. In recent years there was a large current account deficit, which peaked in 2000 at 67.6 b.kr, the equivalent of 10.1% of GDP. Last year the current account deficit was much less, or 33 b.kr., which is 4.4% of GDP. This improvement can mainly be traced to a better external trade balance, less imports and greatly increased exports of marine products and manufactured goods. A large improvement also took place on the services account last year. This year the outlook is for a further improvement in the current account balance, although it will

Chart 5

The current account balance 1997-2001



Source: Central Bank of Iceland.

still be some way from equilibrium. The largest factor at work is high debt service, since the external position of the economy has worsened due to the current account deficit and currency outflow for indirect and direct external investment. Bearing in mind the turmoil that Iceland's economy went through last year, it can only be said that the future is bright and that the economy and financial system have shown their strengths in the sharp landing which has taken place.

Stable financial system

One of the Central Bank's main roles under the new legislation is to contribute to an efficient and safe financial system, including payment systems domestically and with foreign countries. The scope of this task has been steadily growing at many central banks in recent years, as is considered necessary following the deregulation of international capital movements. At international level, growing priority has been given to active supervision of financial activities and an overview of various risk factors in the financial system and the economy, with the aim of preventing serious shocks. The focus on an efficient and safe financial system is consistent with that aim. Most central banks have the objective of contributing to a secure financial system, i.e. ensuring financial stability.

The Central Bank seeks to contribute to a safe financial system by closely monitoring the macroeconomic environment, relations between financial institutions and capital markets, system performance both in Iceland and abroad, its strength and efficiency, and the impact of economic factors on the system as a whole. Twice a year the Central Bank publishes a study of financial stability in Iceland in its quarterly *Monetary Bulletin*. This task differs from conventional financial supervisory activities. Instead of monitoring the position of individual credit institutions, the focus is on potential generic risks faced by the financial system as a whole. In order to contribute towards a sound financial system and consolidate its foundations, the Central Bank and Financial Supervisory Authority work in close cooperation.

The International Monetary Fund now gives growing priority to reports on national financial systems and published one on Iceland in the middle of last year. The IMF delegation's overall assessment was that vulnerabilities existed in the Icelandic financial system. This was particularly the result of the rapid evolution of the financial market in recent years, which in effect had outpaced to some extent the evolution of the regulatory framework. Other factors were imbalances in the macroeconomic environment, notably an enduring, large current account deficit and low national savings rate. At the same time, it was important to recognise that the financial sector was dynamic, appropriately responding to regulatory reform and market signals. There was competence in prudential oversight, and with this background, the authorities appeared to be in a relatively strong position – and to possess the willingness and resolve – to address the existing vulnerabilities, the IMF said.

Since that was written, various reforms have been made to financial system legislation and its regulatory framework, and the economic situation has also slowly taken a turn for the better. Looking at the year 2001 and the results of the financial institutions' accounts then, it is clear that the Icelandic financial system has withstood the pressure from last year's slide in the króna. It is fair to say that no threat of a significant shock looms over the financial system although some individual institutions might face setbacks.

Reforms continued last year in payment intermediation, in line with the greater focus given to this field in the new Central Bank legislation. Chief emphasis has been put on the development of the low-value payment system, for netting of payments which are too small to qualify for the real-time gross settlements system. The minimum amount for RTGS is currently 25 m.kr. The low-value payment system is formally supervised by a dedicated limited company which is owned by Icelandic commercial banks and payment card companies and the Central Bank. The Central Bank has taken the initiative in shaping the low-value payment system. An RTGS system has also been introduced, and makes final settlement of individual payment orders as soon as the balance on the payer's account allows. Thus the RTGS system transfers payments which are above the minimum limit directly to or from the participants' current accounts with the Central Bank. Work is continuing in this area with the aim that, in the near future, payment intermediation in Iceland will fulfil all the main requirements made of such systems at international level.

Interest rate cut

Ladies and Gentlemen:

Under circumstances such as those which have prevailed in Iceland, it is always a moot point when to take monetary action. At the beginning of February the Central Bank considered that, in light of circumstances then, there were "no grounds for cutting interest rates for the time being," as it was put. The fundamentals could change relatively swiftly, however, with exchange rate and price developments in the months to come playing a key role there. The exchange rate trend has been favourable as I mentioned earlier, and the two most recent price measurements suggest a low underlying rate of inflation. Thus the probability that the Central Bank's inflation forecast for this year will hold good seems to have grown. Confirming this impression are the National Economic Institute's most recent statistics showing that the output gap will close completely this year. For these reasons, the Governors of the Central Bank decided today to cut the rate of interest on repurchase agreements with credit institutions by 0.5 percentage points. Nonetheless, the monetary stance remains tight, as is necessary in order to ensure an acceptable rate of inflation.

I would like to conclude by expressing my thanks for our good cooperation with the government, financial institutions and the organisations with which the Central Bank has been involved during the year.