Address

by Birgir Ísleifur Gunnarsson, Governor and
Chairman of the Board of Governors, Central Bank of Iceland,
at the Bank's Annual Meeting, March 30, 2005

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 44th annual meeting. The Bank's financial accounts for the year 2004 have been ratified today by the Prime Minister. The Bank's annual report has also been published. It includes a survey of the Bank's activities and operation, along with a report on the Bank's monetary policy and actions, the financial system, financial stability and the financial markets, and the main features of economic developments in the course of last year.

Under the Act on the Central Bank of Iceland that was passed by Parliament four years ago, the main objective of monetary policy is price stability. The joint declaration by the Government and the Central Bank from March 27, 2001 set a formal inflation target for the Central Bank, i.e. it is obliged to aim at a rate of inflation, measured as the annual twelve-month increase in the CPI, of as close to 2½% as possible. Since price stability is the Bank's main objective, monetary policy will not be applied to achieve other economic targets such as a balanced current account, high level of employment or specific exchange rate, except insofar as these are compatible with the Bank's inflation target.

Inflation rose in 2004 after being close to or marginally below the 2½% target since the end of 2002. The rate of inflation was 4% from the beginning to the end of the year. At the beginning of March this year, inflation measured 4.7%, having moved above the 4% tolerance limited defined in the joint declaration by the Government and the Central Bank from March 2001. When 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. Such a report was sent to the Government on February 18 and published the same day.

There are a number of explanations for the recent rise in inflation. Large investments in aluminium smelters and power sectors have built up demand pressures in the economy. These investments will be stepped up this year, when they will peak instead of in 2006, as assumed under earlier plans. Investment cost this year is estimated at 85 b.kr., or almost 10% of GDP in 2004. New conditions in the credit market have also driven inflation. Plans by the Housing Financing Fund (HFF) to raise its loan-to-value ratio and maximum mortgage amounts prompted a response from the banks, which began offering mortgage loans on far easier terms than had been customary. So far the main impact of increased credit supply on the price level has been through the housing component of the Consumer Price Index (CPI). In the beginning of March the twelve-month rate of increase in housing prices was 24%. Excluding the housing component, the CPI had increased by 2% over the same period. Housing inflation has therefore clearly made a major contribution to total inflation in recent months. Another cause of concern is inflation in services. Over the past twelve months, prices of public services have risen by 6.9%, driving up the CPI by 0.5 percentage points, and private sector services by 3.5%, adding a further 0.8 percentage points. Rising prices of private sector services have often been an indication of mounting demand pressures.

According to estimates by Statistics Iceland, GDP growth amounted to 5.2% in 2004, on the back of 4.2% growth in 2003. Faster GDP growth was largely the result of a continued surge in national expenditure, while exports also increased significantly after a low in 2003. Private consumption also continued to firm up during the year with an estimated growth rate of 7.5%, the fastest for five years. Real disposable income increased more slowly than in 2003, but private consumption was spurred by lower mortgage debt service and easier access to credit. Investment grew by an estimated 12.8%, somewhat less than in 2003. GDP growth in the euro area is estimated at 1.9% in 2004 and growth prospects are lean for the years to come. This shows yet again the difference in the economic challenges faced by Iceland and the rest of Europe, since policies there aim at stimulating the economy, whereas Iceland's problem is to try to prevent overheating.

The widening current account deficit is also a cause for concern. Last year it is estimated at 70 b.kr., the equivalent of 8% of GDP. Exports increased by 12% in 2004 after being virtually stagnant in 2003. The strong value of the króna, robust private consumption and stepped-up investments in aluminium-related projects are reflected in substantial import growth during the year. Merchandise imports were up by 23% in real terms, the sharpest increase since 1998. Roughly one-third of the current account deficit may be attributed to investments in the aluminium and power sectors. The current account deficit is forecast to widen even further in 2005, but will also peak this year instead of in 2006, as had been forecast earlier.

Unemployment declined slowly last year despite brisk economic activity. It was not until the closing months of the year that labour market statistics indicated mounting pressures. Seasonally adjusted unemployment measured 2.4% in February and vacancies have soared. To some extent, growing labour demand was met with imported labour; issues of new work permits almost doubled in 2004. However, the number of new work permits has not increased year-on-year over the past quarter. More labour has been imported to meet the labour requirement on aluminium and power sector projects, but it has increased in other sectors as well.

Private sector wage settlements agreed in the first half of 2004 were broadly uniform and their cost effect more or less consistent with the inflation target. The settlements are in force for four years but may be renegotiated at the end of 2005 and 2006 if inflation moves out of line with the target and the increased wage costs that they imply are not adopted across the labour market in general. This is one example of the importance of keeping inflation as close to target as possible later this year.

When Iceland moved onto an inflation target, this involved abandoning the fixed exchange-rate regime and allowing to the króna to float in the market. Experience has shown that, in a climate of unrestricted cross-border capital movements, it is impossible for a central bank to control the exchange rate. Central Bank interest rate decisions admittedly affect the nominal exchange rate, but many other factors operate as well. Thus it is totally unrealistic to insist that the Central Bank should keep the exchange rate at a certain level and find the right combination of interest rates and exchange rate, whatever that may be. To do so, the Bank would either need to abandon its inflation target or impose foreign exchange restrictions, which of course is unrealistic. After depreciating at the beginning of 2004, the króna remained fairly stable until it appreciated noticeably towards the end of the year. It continued to appreciate in the New Year and is currently higher than it has been since early 2000.

The exchange rate of the króna has a widespread impact on the Icelandic economy. It directly affects the prices of imports and exports of goods and services. The combined value of Iceland's imports and exports in recent years has been equivalent to 75-80% of GDP. The real exchange rate may be defined as the development of domestic prices or unit labour costs relative to trading partner countries, based on a given reference year and measured in the same currency. A rise in the real exchange rate implies that prices or labour costs in Iceland have increased by more than among trading partner countries after adjustment for changes in the exchange rate, i.e. the competitive position of domestic sectors has deteriorated. When it was decided to launch the large-scale investment projects for the aluminium industry that are currently under way, it was perfectly clear that the real exchange rate of the króna would rise considerably, as the Central Bank repeatedly pointed out in its public statements. In particular, the real exchange rate would be driven up by a rise in the nominal exchange rate caused by heavy capital inflows. If inflation could not be kept under control, the real exchange rate would also increase as a result.

Thus the task has primarily involved controlling the way that developments unfold, and in the Central Bank's view the worst path would have been if the real exchange rate had been driven up by domestic inflation. We are familiar with such cycles from historical experience and neither businesses nor households benefited from them. The Central Bank's approach was therefore to raise its policy interest rate, causing a corresponding increase in the nominal exchange rate, in an attempt to prevent the real exchange rate from rising in step with inflation. An easier monetary stance may lead to a lower nominal exchange rate in the short run, but not to a lower real exchange rate in the long run. Lower interest rates would eventually lead to more inflation and wage rises, which in the final analysis would probably move the real exchange rate to broadly the same level as if monetary policy had been kept tight from the outset. The chief difference would simply be a much higher rate of inflation when the inevitable exchange rate adjustment arrived as the aluminium-related investments came to an end. There is no question that the high real exchange rate has squeezed the export and traded goods sectors, but it was known that such difficulties would emerge when the investments peak, so it should not have come as a surprise. However, the sectors that have been affected would be in an even tougher position with a lax monetary stance at present, which would leave us facing a much higher rate of inflation and a strong real exchange rate at the end of this expansionary episode. Tightening the monetary stance under such conditions could also provoke problems and shocks for the financial system, with unforeseeable consequences.

The real exchange rate is heading for a historical high this year which is unlikely to be sustainable for very long. It is important to engineer as soft a landing as possible. In this context I want to mention the study in the latest *Monetary Bulletin* which shows that the real exchange rate is no more volatile in Iceland than in other countries, for example other inflation-targeting countries with which we often compare our performance. On the other hand, the importance of foreign trade varies from one economy to the next, so exchange fluctuations have a different impact on households and business in different countries.

According to the Central Bank Act, one of the Bank's roles is to promote an efficient and safe financial system, including payment systems domestically and with foreign countries. I shall not dwell on financial stability issues on this occasion. The reason is that the Central Bank will be publishing a separate financial stability report in April which will include its assessment of the position of the financial system. However, I would like to mention two points which are closely related to financial stability. One is the noteworthy overseas expansion by Icelandic banks, which has major ramifications for the financial system. Among the changes that this entails is that the banks are now less exposed to volatility in the Icelandic economy, because of the large share of their activities that has been transferred abroad. At the same time, they are left more prone to shocks originating in foreign markets. This development calls for a review of the Central Bank's working procedures. I shall not go into details here of possible changes, which were discussed in *Monetary Bulletin* last autumn.

The other point is the growth in lending by the credit system, in particular by the banks. The surge in lending over the past two years is a cause of concern both for financial stability and the Central Bank's inflation target. Accounts of the credit system are published quarterly and the most recent statistics show that lending by the credit system as a whole increased by 16% in real terms last year. The credit system embraces all undertakings involved in lending activities, including the HFF and the pension funds. The latest figures for the largest credit institutions show that domestic lending by the deposit money banks (DMBs) grew by 40% over the twelve months to the end of February. By far the greatest increase has been in mortgage lending. From August to the end of February the DMBs had disbursed 14,500 mortgage loans, for a total of 158 b.kr. In the opposite direction, pension funds' loans to members contracted over the same period by 6 b.kr. and lending by the HFF by 59 b.kr. The transfer of mortgage lending to the banking system is beneficial and will strengthen it in the long run. However, the timing of this development during a strong expansionary phase is inappropriate. Given the way that events have unfolded, a review of the role of the Housing Financing Fund and the legislation governing it has become very necessary.

Excluding their direct foreign operations, the DMBs' foreign debt amounted to 1,200 b.kr. at the end of January, and had grown by 561 b.kr. over the previous twelve months. The lion's share of this debt is long-term, which is a great improvement from the times when the banks were overdependent on short-term borrowing for their funding. Their foreign assets have grown as well, but not in pace with their debts. Foreign assets of DMBs amounted to 590 b.kr. at the end of January, having grown by 312 b.kr. over the previous twelve months. Iceland's external debt, which is largely comprised of the banks' foreign debts, is one of the weakest links in its economy. All the agencies that issue sovereign ratings for Iceland identify this as a risk and warn that increased indebtedness could lead to a downgrading of its credit ratings. The banks therefore bear a great responsibility in this respect.

The only conclusion that can be drawn from the massive growth in lending by the banks is that they have overstepped the mark. There is no question that this surge in lending is a major contributor to the current expansionary forces in the economy, which have fuelled inflation and call for a higher policy interest rate than otherwise. The banks are a pillar of the Icelandic economy. They insist that the Central Bank and the Government should act with restraint and promote economic stability, so they also have to make comparable demands towards themselves. In the long run, no economy can sustain this huge expansion in credit that originates in the banking system.

Last week the Central Bank published its quarterly *Monetary Bulletin* in which it discusses economic and monetary developments and prospects and has published its new macroeconomic forecast. Without going into detail here, the broad finding is that robust private consumption will continue and investment will increase, especially business investment, for reasons including that aluminium-related projects have been stepped up for this year, as I mentioned earlier. Public consumption growth is expected to be modest, however. GDP growth will be 6.4% this year. It will be marginally less next year, when growth of private consumption and investment will also slow down. The positive output gap will widen considerably this year and in 2006. This year the current account deficit will peak at 12% of GDP, then shrink next year, contrary to previous forecasts. From all this it is clear that the economy will be characterised by vigorous expansion this year and into 2006.

According to the inflation forecast also published in *Monetary Bulletin*, the outlook for inflation has improved since the previous forecast in December but will remain above target two years ahead. The higher policy rate and a substantial appreciation of the króna will subdue domestic demand and dampen rises in import prices, especially in the short term. Inflation will therefore be somewhat lower over the forecast horizon than was forecast in December. The Central Bank forecasts an inflation rate around the 2½% target one year ahead, which is lower than forecast in December. Two years ahead, inflation is forecast at just over 3%, which is also somewhat lower than the rate forecast in December, although still above target.

It is important to remember that an unchanged monetary policy stance and unchanged strong exchange rate are assumed over the forecast horizon. The forecast describes the way that the Bank considers developments are most likely to unfold if it takes no further measures than it had already taken. Obviously, uncertainty increases over the horizon of the forecast. A particular uncertainty is the exchange rate, which is at a historical high at present as I have discussed, posing a higher probability that it will give way over this period and inflation will increase. In light of this forecast, at the same time as *Monetary Bulletin* was published the Central Bank decided to raise its policy interest rate by 0.25 percentage points, which is a somewhat lower hike than market agents had predicted and also less than the Bank's other recent policy rate rises. The policy rate is therefore currently 9%. Among other things, the decision to take a relatively modest step now is based on the fact that the tightening implied by the recent policy rate hikes and the significant appreciation of the króna have yet to be transmitted in full. Nonetheless, further tightening may be necessary over the next few months.

Comparisons with previous forecasts and various indicators suggest that since December the Central Bank's policy rate hikes have by and large delivered a tighter stance. The Central Bank's monetary policy is very much debated in society at large at the moment, which is natural given the great interests at stake. Obviously I have closely followed discussions of monetary policy for a fairly long time and must admit that the debate in recent times has been more mature and bears witness to a deeper understanding of economic principles than before. It is normal for opinions to be divided over the Central Bank's measures during tight stances such as the present. The Central Bank welcomes public debate and is ready to take part in it. I would like to use this opportunity to address a few points that have been raised in this debate recently.

Sometimes it is alleged that monetary policy is impotent in a climate of heavy capital inflows. Claims are also heard that the Central Bank's monetary policy measures only exert an influence through the exchange rate and have no effect on long-term interest rates, and absolutely not on indexed interest rates. Certainly, a tight monetary stance does put significant upward pressure on the exchange rate, contributing to lower inflation in the short run. Central Bank policy rate hikes also have a very swift effect on the money markets, and interest rates on other instruments with maturities of a few months or years are soon influenced too. Central Bank policy rate decisions also have an impact on long-term interest rates, both indexed and non-indexed. All research in Iceland and everywhere else confirms this, but because the effect is transmitted with a long lag, monetary policy must be forward-looking. Interest rate decisions made today are not transmitted in full to long-term interest rates until one or two years hence. Thus the debate often focuses on the short-term effects of monetary policy, but people need to be patient and bear in mind the impact which does not emerge until well into the future.

The Central Bank does not have the slightest doubt that interest rate changes in Iceland ultimately have the same effect as those in other countries, in other words that general economic principles apply just as much in Iceland as anywhere else.

When monetary tightening is beginning to have an effect and specific sectors of the economy bear the brunt, it is normal to ask whether there are no softer alternatives, which preferably affect no one. In the search for such approaches, it is sometimes claimed to be preferable to target liquidity through minimum reserve requirements, rather than interest rates, or to change the composition of the CPI, for example by excluding housing costs, which in fact would leave the rate of inflation within the target at the moment. The Central Bank has explained its position towards both these ideas. Regarding minimum reserve requirements, the Bank has pointed out that strong domestic financial institutions have various possibilities for sidestepping the effects of tighter liquidity. Individual credit institutions would therefore be affected very unequally. Such a measure would doubtless hit the savings banks very hard, since they do not have the same scope as the commercial banks for sidestepping the effects. International experience also shows that the impact of changes in minimum reserve requirements is extremely difficult to predict. For individual institutions, the consequences could be very significant. This is the main reason that none of the world's main central banks use changes in minimum reserve requirements as a policy instrument any longer. However, even if liquidity worked, their impact on interest rates and the exchange rate would be broadly the same as raising the policy rate, although the transmission mechanism might be different, and they would affect individual segments of the credit system unevenly. In addition, changing the minimum reserve requirement is not a transparent measure and its impact on expectations is unpredictable.

The Central Bank firmly advocates that housing costs should remain part of the reference index for the inflation target, and believes that by and large the best available methodology is being used by Statistics Iceland to evaluate them. This is because housing costs are a major item in household consumption in Iceland, where the level of owner-occupancy is 80%. Excluding changes in housing prices would ignore a large proportion of household expenditures. Experience also shows that housing inflation has the advantage, from the perspective of central banks on an inflation target, of being a leading indicator of general inflation later on. Presumably this is because the housing market is independent from foreign markets. Increased housing demand cannot be channelled out of the economy, unlike various other goods and services, nor is foreign competition present to any significant extent. When demand surges, housing prices often rise sooner and by more than prices of goods and services in general. It may be added that if housing prices had not been included in the CPI, the rate of inflation would have exceeded 10% in the recessionary year of 2001, which would have demanded even tougher measures on the part of the Central Bank than were applied then.

Standard & Poor’s recently upgraded its credit rating for the Republic of Iceland, which now has very good ratings from the three main sovereign ratings agencies, i.e. Standard & Poor’s, Moody’s and Fitch. All the agencies keep a very close watch on economic developments in Iceland. Because Standard & Poor’s has recently upgraded Iceland’s sovereign rating, it is interesting to examine the main points in its rationale, both the positive factors that support the rating and others that are identified as potentially weakening it.

The agency says that its upgrade reflects significant and sustained improvements in the resilience and structure of the Icelandic banking sector. Improved regulation and supervision leave the financial sector much more resilient. The recent entry of the commercial banks into the Icelandic mortgage market provides the private financial sector with additional domestic stability and profitability. Public finances continue to be healthy and Iceland boasts stable and flexible political institutions.

However, the agency also points to very high and rising levels of net external debt throughout the economy, high current account deficits and relatively poor external liquidity. Adherence to the government's medium-term fiscal framework is central to maintaining the ratings and further unforeseen adjustment would need to be accommodated through fiscal policy, not monetary policy. Any significant increase in net external leverage or a recurrence of entrenched macroeconomic imbalances on the back of the large investment projects could weaken Iceland's creditworthiness. These were the main points highlighted by Standard & Poor's and there is every reason to take them seriously. Of course it is crucial for the Republic to enjoy a good credit rating. It is important for the Treasury's access to markets and investors, and for its credit terms. Iceland's sovereign rating also represents the ceiling for ratings of Icelandic banks and other rated institutions. Favourable ratings are vital for the banks' expansion abroad and for their growing need for easy access to foreign credit. Thus the Treasury and the banks share an interest in Iceland being able to maintain its good credit rating.

Ladies and Gentlemen

As I mentioned earlier, the Central Bank raised its policy interest rate by 0.25 percentage points last week. The Bank has thereby raised its policy rate by 3.7 percentage points since its first hike in May last year. These measures reflect the Central Bank's view that, given the current economic situation and the scenario two to three years ahead, it is much more effective to ensure a sufficiently tight stance in good time rather than to wait and take action later. Belated measures to tighten the monetary stance entail a risk of higher inflation afterwards, and thereby a far greater risk for the financial system, businesses and households. It is crucial to take immediate measures to tackle the inflation that we see on the horizon. This is the Central Bank's mandatory role and the Bank is determined to perform it. The more that other economic agents contribute towards containing expansionary trends, namely the central government, local government and credit institutions, the easier it will be to ensure long-term stability. The successful economic policies of past years must not be swept aside in favour of short-term solutions that would ultimately only backfire.