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

Address to the Annual Meeting, March 27, 2001¹

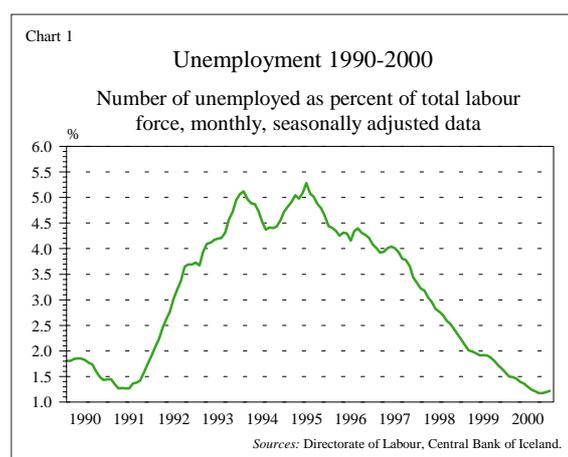
On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 40th annual meeting. This year marks the Bank's fortieth anniversary after it was made completely separate from Landsbanki and transformed into an independent institution. The Bank's financial statements for the year 2000 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 actions, the financial system and financial markets, and the main features of economic developments in the course of last year. I shall now address several aspects of economic issues and the present prospects, in particular those most closely connected with the Central Bank's field of activities.

Overheating of the economy

Iceland has distinguished itself from most other industrialised countries in recent years by the strong economic growth it has enjoyed, or 4-5% per year. The closest comparison in this respect is with the USA, where growth is in fact on a downward path now. As Iceland's growth period progressed, symptoms emerged of the economic overheating which has been one of the main concerns of the Central Bank in the implementation of monetary policy in recent years.

For the Icelandic economy, the period from 1990-1995 was one of stagnation, apart from 1994 when

growth shot up to 4.5%, only to fall back to virtually zero the following year. In 1996, however, the growth phase began which we have been enjoying ever since. Over this period, the entire output gap that was present then was closed, and more besides. National expenditure has been growing at a faster rate than national income, resulting in a large current account deficit. National expenditure rose by more in 2000 than the preceding year, so the current account continued to widen. GDP growth was less than the year before, although it did not slow down sufficiently to ease output pressure. In all likelihood, the overheating that has characterised the Icelandic economy in recent years peaked in 2000, since there were indications of a slowdown in domestic demand growth in the course of the year, although it remained very strong. The outlook is for a substantial reduction in the rate of economic growth in 2001.



1. Translated from Icelandic.

Clear signs of overheating were seen in the labour market. Seasonally adjusted unemployment decreased from 1.5% in January 2000 to 1.2% in July, then remained unchanged to the end of the year. One response to labour shortages was to bring in workers from abroad, which together with longer working hours has prevented wage drift from being felt on any great scale. Labour market surveys, however, show contrasting pictures in the Greater Reykjavík Area and regional Iceland. There is an obvious shortage of labour in various fields in the urban southwest, while availability of employment declined in the regions.

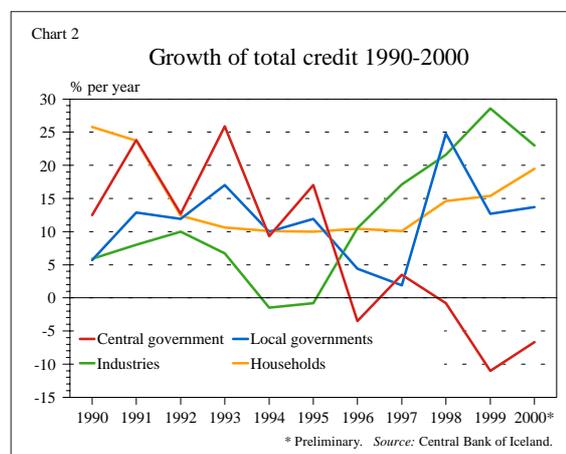
Great pressure built up in the real estate market, largely reflected in a rise in real estate prices in the Greater Reykjavík Area. Prices peaked at the beginning of 2000 after increasing by almost 24% over a twelve-month period. This rate of increase has now begun to slow down, and by the end of December real estate prices had risen by 13.3% over the preceding twelve months.

Credit expansion

In the course of the growth period, generous wage agreements were made which boosted real disposable income. The greatest increase in real disposable income was in 1998, or 7.2%. Otherwise it rose by 4-5% annually until last year, when the figure was close to 2%. Over this period, Iceland Stock Exchange has gone from strength to strength. An important equities market has evolved in Iceland, and share prices followed an upward trend until last year. Greater real disposable income and rising share prices, which at least for a while increased shareholders' confidence in their own prosperity, fuelled growing optimism among consumers and investors. At the start of the period economic growth was sustained in particular by investments in business sectors such as power-intensive industry and fisheries. This gradually changed in character and for a while growth was primarily borne up by private consumption and related expenditure. Last year capital formation increased more than had been expected, however, by an estimated 9% during the year. Private con-

sumption rose somewhat more than real disposable income, and household debt increased by 14½% in real terms, and as a proportion of disposable income from 146% to 163%.

The combined impact of all these factors was to put pressure on Iceland's credit system, not least the deposit money banks which have been lending immoderately. In the first half of 1999 the twelve-month rate of lending growth was 35%, although it has since slowed down. DMB lending increased by just over 26% last year, somewhat more than in 1999. Total lending by the credit system rose by 18.4%. The largest growth was in corporate lending, or 23%, while household lending growth was slightly less at 19%. In comparison with 1999, household lending growth increased but corporate lending growth slowed down somewhat. Excluding exchange rate and price indexation adjustments, the total annualised increase in lending by DMBs during the second half of 2000 was just under 14%, compared with 22% during the same period in 1999. Lending growth has clearly slowed down, although it is still too great to be compatible with long-term stability.

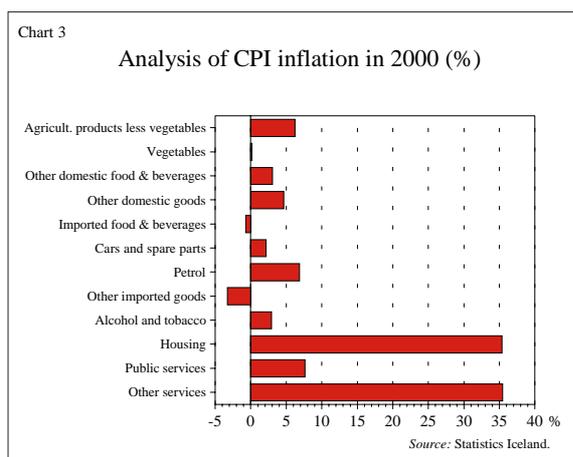


Heavy lending by commercial banks swells their balance sheets and weakens their equity positions by the same token. The combined equity ratio of the three commercial banks was 10.21% at the end of 1999, but was down to 9.35% at the end of 2000. The mandatory minimum equity ratio is 8%. In part the

equity position is maintained with subordinated loans, as authorised by law; excluding these, the equity ratio was 7.93% at the end of 1999 and went down to 6.28% at the end of last year. This is a cause for concern, as the Central Bank has repeatedly pointed out. It leaves the commercial banks worse equipped to tackle tougher economic times than would otherwise be the case.

Inflation

Overheating of the economy generated inflationary pressures after spring 1999. Inflation gradually climbed in 1999 and until spring last year, when the twelve-month rate of increase measured 6%. It slowed down again as the year wore on and measured 3.5% from the beginning to the end of the year. Over the twelve months until the beginning of March this year, inflation was 3.9%.



Both domestic overheating and external conditions contributed to the high inflation figure shown last year. Three main factors were at work. Housing prices led to a 1.25% increase in the Consumer Price Index. Petrol prices pushed the CPI up by just under 0.25%, compared with almost 1% the previous year. Finally, market services, i.e. those not provided by the public sector, began rising soon after the signing of the first wage agreements, which also involved the largest section of the labour force. The effect was a 1.25% rise in the CPI. In combination, rises in hous-

ing, petrol and general service prices explain almost seven-tenths of the CPI increase last year. Housing prices have probably reached their peak, and the same may be said about oil prices. These factors are therefore not likely to cause a rise in the CPI this year; if anything, they could bring it down. Iceland's inflation rate moved some way closer to the levels pertaining among its European trading countries in the course of the year, as measured by the Harmonised Consumer Price Index for the European Economic Area. At the beginning of the year, twelve-month inflation in Iceland measured by the HCPI was 4.6%, or 2.7 percentage points higher than among main trading partner countries. By December the twelve-month rate in Iceland was down to 3.7%, which was 2.3 percentage points above the average among main trading partners and lower than in five of the seventeen countries in the European Economic Area that calculate the same monthly index using the same terms.

The Central Bank publishes its inflation forecast four times a year. At the beginning of last year it forecast a 5% rise in inflation between the years, which turned out to be the case. When the króna depreciated, the Bank's mid-year inflation forecast assumed that the impact would soon be felt in prices. This prediction did not materialise in full. During the second half of the year it seemed clear that there would be some lag between the depreciation and its effect on the price level. This prompts questions about the correlation between prices and exchange rate developments. The short-term relationship of these factors appears to have weakened, which is undoubtedly explained in part by market competition. A more flexible exchange rate policy is also unquestionably at work. In earlier times, when devaluations were made amid extensive announcements, the change was in general rapidly reflected in the price level, since it was fairly certain that it would be permanent. After the exchange rate was made more flexible, it can be assumed that uncertainty about the permanence of changes has led buyers and sellers of goods to take more short-term exchange rate risk than before, since high costs are involved in making

frequent alterations to prices. However, it is imprudent to ignore the eventual impact of a depreciation on prices, since research offers no support for such a view. This is one of the assumptions on which the Bank bases its forecast from this February, where inflation is expected to run at 4.3% between 2000 and 2001 and 4.6% from the beginning to the end of the year. Next year it is forecast to slow down to 2.7% from the beginning to the end of the year.

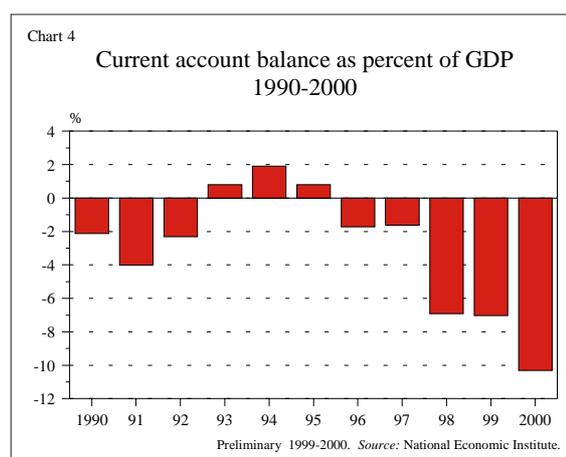
Interest rates

The main objective of the Central Bank of Iceland, like those in many other countries around the world, is to promote price stability. An intermediate objective has been to secure the value of the króna. To do so, the Bank applies its policy rates, namely the rates of interest that it sets for its transactions with credit institutions. In a scenario of overheating and inflationary risks, the Central Bank raises its interest rates, as it has been doing in recent times. The Bank already took such action in the second half of 1997 and raised interest rates fairly rapidly in 1999 and 2000. Over these two years, the Central Bank raised its interest rates seven times in all, by a total of 3.6 percentage points. The policy rate is now 11.4%, which is very high by international comparison. However, under certain circumstances interest rates have been this high or even higher in various other industrialised countries.

Broadly speaking, these interest rate rises served a double purpose. Firstly, they were aimed at influencing the exchange rate differential with abroad, thereby exerting a direct impact on capital inflows and supporting the exchange rate of the króna. The other purpose was to contribute towards higher interest rates at credit institutions and thereby reduce the expansion in their lending. Experience shows that the impact on lending will emerge eventually. All these measures were aimed at reducing consumption and investment. There are many signs that the Central Bank's interest rate rises are producing results in the form of less activity in the areas of the economy which are most sensitive to interest rates. Had the Central Bank not reacted in this way, it is quite cer-

tain that overheating of the economy would have produced a much higher rate of inflation than Iceland has known in recent years, with corresponding consequences for the economy.

The Central Bank's tight monetary stance has been quite widely discussed in Iceland. Questions raised have included its impact on the current account deficit and whether monetary policy was actually achieving its set aims, given unrestricted access to foreign capital and the insensitivity of households and businesses to interest rate changes. The Central Bank has made special studies of the impact that interest rate rises have on the real exchange rate and current account deficit. Research suggests that, since 1996, the tighter monetary stance has led to a 2-3.5% appreciation of the real exchange rate. At the same, the real exchange rate appreciated by 10.5%. Studies also indicate that this appreciation in the real exchange rate caused the current account deficit to widen by 0.5-2% of GDP, but that it will shrink again in the course of time. Bearing in mind that last year's current account deficit was equivalent to 10% of GDP, rises in interest rates have clearly not had much impact on it. A wide range of other obvious factors are at work there. Suffice it to mention large-scale investment in power-intensive industries and other sectors during the first half of the period in question, a major increase in real disposable income in the past few years and credit expansion which has been funded by foreign borrowing. The Central



Bank's monetary policy has therefore played a minor role in this development and its impact has primarily been of a short-term nature and will eventually be levelled out. Of course, the Central Bank is also aware that open access to foreign capital softens the impact of its monetary policy. However, it should be borne in mind that access to foreign capital is not unlimited in the final analysis, and is neither risk-free nor available to all Icelandic companies. Household and corporate sensitivity to interest rate changes may be low at present, but in the long term the impact of higher interest rates cannot be avoided. The Central Bank is convinced of the impact that its interest rate instruments have, and recent discussions about high interest rates can be cited as precisely such evidence that their impact is being felt in full.

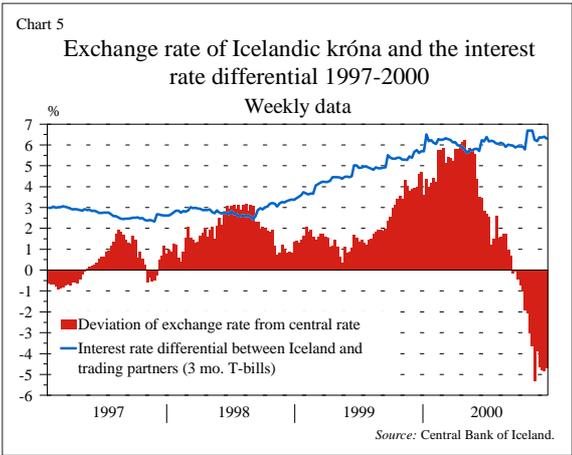
Furthermore, the Central Bank has been accused of basing its assessments of economic developments on somewhat outdated data. Undoubtedly there is always scope for improvement, but the Central Bank does compile extensive data about financial market developments on a monthly basis, and various other data even more frequently. Its data on the exchange rate of the króna, for example, cannot be more up-to-date. Naturally, the Bank uses data supplied by other agencies as well. It also acquires information through other channels, such as both informal and formal meetings. For this reason it is simply wrong to claim that the Bank's resistance to easing its monetary stance is based on outdated information.

The Central Bank has declared that it will maintain tight money until unequivocal signs of a cooling in the economy begin to appear. Such indications have been emerging recently. For example, total business turnover has decreased. Retail turnover has contracted sharply and there has also been a decrease on the wholesale side. Turnover in manufacturing appears to be stable. However, turnover is still rising rapidly in the construction industry and at a considerable rate in the service sector as well. Although credit growth is still quite substantial, it has slowed down. In the Central Bank's opinion, the economy has now passed the most difficult phase of overheating and the time is ripe to ease the monetary stance

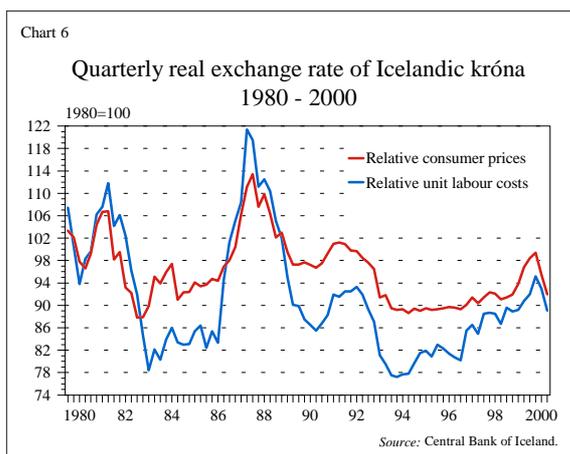
somewhat, among other things to avoid a hard landing. The Board of Governors therefore decided today to reduce the rate of interest on its repurchase agreements with credit institutions by 0.5 percentage points. This change has been made in light of next year's lower inflation scenario alongside the slow-down in economic activity. Inflation prospects are within the reference limits stated in the joint declaration on an inflation target issued today by the Government and Central Bank. In weighing up this decision, interest rate reductions among some of Iceland's trading countries in recent months have also been taken into account.

Exchange rate

To reiterate, the main objective of monetary policy is price stability. Since the exchange rate is an important determinant of prices, exchange rate stability has been an intermediate objective of monetary policy. During the first four months of last year the króna appreciated somewhat, but this trend was reversed in the middle of June and the currency was under pressure for most of the time until the end of the year. It depreciated by almost 9% from the end of 1999 to the end of 2000. To some extent the depreciation was triggered by fishing quota cutbacks and the resulting deterioration in the economic outlook. Demand for foreign exchange also outstripped supply because of last year's current account deficit, which is estimated at ISK 68.9 billion, as well as heavy investment by



Icelanders in foreign securities amounting to almost ISK 40 billion net. Pension funds play the leading role in these investments. By the end of 2000, the real exchange rate of the króna had fallen below its average for the past twenty years.



Actions in the foreign exchange market

Under the prevailing circumstances, the Central Bank considered it necessary to take action to counter the depreciation of the króna. Besides raising its interest rates, the Bank intervened in foreign exchange markets thirteen times after the middle of 2000 in order to cushion against sharp fluctuations. These actions marked a turning point, since the Central Bank had not traded in the interbank foreign exchange market since the middle of 1999. The Bank sold US dollars for ISK 15.6 billion over the period. So far this year the Bank has taken action in the foreign exchange market six times, and the króna has depreciated by 2.3% based on today's rate.

There is no denying that Central Bank intervention has put pressure on the currency reserves. The Bank maintains a specified minimum reserves which is now ISK 34 billion. If the reserves head below that floor, the Bank borrows to maintain it. Short-term borrowing by the Central Bank now amounts to ISK 24.2 billion. The Central Bank has made extensive contingencies for bolstering the exchange rate if the need arises, most recently with an agreement with a German bank on access to a new USD 250 million

credit line. It should also be mentioned that yesterday the Treasury made overtures in the European market for a credit facility of 250 million euros, of which 180 million euros will be used to refinance debt that will mature shortly. The remaining 70 million euros (ISK 5.6 billion) will be deposited in a foreign currency account at the Central Bank to boost the currency reserves. Talks have been held with the Minister of Finance on more action of this kind to strengthen the currency reserves. Most of the Central Bank's committed foreign credit facilities are still undrawn.

When the foreign exchange market was established in May 1993, a central exchange rate was set with a fluctuation band of 2¼% in either direction. In September 1995 this was extended to ±6%. In February last year the band was extended once again, to ±9%. Last year's fluctuations in the króna used up all the scope allowed by exchange rate policy before the last extension of the fluctuation band.

The króna depreciated considerably after the middle of last year. The Central Bank has stated before that it does not identify a high real exchange rate as the root cause of the current account deficit. As pointed out earlier, the real exchange rate has now fallen below its average for the past twenty years. Any further depreciation is unlikely to lead to a sudden improvement in the current account balance. On the contrary, a depreciation of the króna would entail risks for domestic companies with foreign-denominated liabilities, especially those with no foreign revenues to match them. Thus it is very much in the interest of these companies – and the credit institutions which have acted as intermediaries in procuring foreign borrowing – that the króna does not depreciate to any extent. These viewpoints, among others, have been borne in mind in the Bank's monetary policy. A weaker króna would have a multiple impact in the form of higher inflation, not least in the climate of overheating which has prevailed in Iceland recently, a resulting fall in living standards and difficulties for companies and credit institutions.

Exchange rate policy reforms

For quite some time now the Central Bank has been examining the option of abolishing the formal fluctuation band for exchange rate policy and adopting instead direct inflation targeting as the basis of monetary policy. Articles on this topic have appeared in the Bank's publications in recent times and international agencies have recommended serious consideration of inflation targeting as the main monetary policy goal. The fixed exchange rate framework has gradually been eased and the fluctuation band has been extended in phases, as I mentioned earlier. Indeed, the extension of the band in autumn 1995 can be claimed to represent the first step towards instituting a new foreign exchange framework, with the next step taken in February last year. The Central Bank sees many factors in favour of adopting inflation targeting, which is a logical continuation of the flexible exchange rate policy that has been pursued. Monetary policy based on formal inflation targeting enjoys growing support and has been adopted by an increasing number of countries. Industrialised nations which have done so include Australia, the UK, Canada, New Zealand, Switzerland and Sweden. Various other countries have also adopted such a policy, and there are good arguments for claiming that the US Federal Reserve and the twelve members of the European Monetary Union also in effect follow such a policy, although their monetary policies also have other characteristics.

Under this arrangement, specific targets are set and the Central Bank will keep the rate of inflation consistent with them within a specified timeframe. At the same time, the exchange rate is no longer used as an intermediate target and the fluctuation band is abolished. However, it should be underlined that the exchange rate always exerts a strong price impact in an open economy. Monetary policy will therefore continue to take exchange rate developments into account. The Central Bank will implement the policy by producing an inflation forecast, and if this indicates that inflation is heading beyond the target, the Bank will be obliged to respond by applying its monetary instruments. Conditions for credible implemen-

tation of this policy are that the Central Bank must be granted full independence to apply its instruments in order to achieve the targets which have been set, monetary policy must be transparent and a smooth flow of information from the Central Bank to the general public and government authorities must be ensured. Furthermore, the new regime makes great demands of the Central Bank since inflation forecasts will be a crucial tool in the formation of monetary policy and it is vital for them to be firmly founded. For some time now the Central Bank has been preparing for these reforms, among other things by strengthening the instruments at its disposal.

Current legislation on the Central Bank assumes that exchange rate policy decisions are the joint task of the Government and the Bank. Talks about this issue have been in progress for some time between the parties involved. A conclusion has now been reached, as the Prime Minister announced in his preceding address. The Central Bank welcomes the exchange rate policy reform decision and is convinced that it will strengthen the foundation of Iceland's economy. It is vital to bear in mind that the exchange rate has a strong impact on prices in an open economy. For this reason, monetary policy will need to take exchange rate developments into account. I would like to draw particular attention to the statement in the joint announcement by the Government and Central Bank that despite the elimination of the fluctuation limits for the króna, the Central Bank will intervene in the foreign exchange market in order to promote the inflation objective, if it thinks that exchange rate fluctuations might undermine financial stability.

In the past few days some unease has developed in the foreign exchange market and the króna has slid somewhat. There is little doubt that this unease is linked to uncertainties about the exchange rate framework reform and widespread discussion about the conceivable adoption of inflation targeting. The Central Bank does not consider that the depreciation can be justified by fundamentals and, now that uncertainties have been dispelled, conditions are at hand for restoring calm in the foreign exchange mar-

ket, and possibly even for the recent depreciation to be reversed.

Ladies and Gentlemen

Three major decisions involving implementation of monetary policy have been announced at this meeting.

The Government has agreed to present a bill to parliament proposing a new Central Bank Act which entails a modernisation of the legislation on the Bank and will strengthen its position for tackling monetary issues. The Bank welcomes the new bill.

The Government and the Central Bank have issued a joint declaration on inflation targets and exchange rate policy reforms. Experience from other countries shows that such a framework has estab-

lished a firm basis for implementing monetary policy and contributed towards price stability.

The Central Bank has also announced its decision to reduce its policy rates by 0.5 percentage points. This is a reflection of the Bank's assessment that the economy will begin to cool this year and that the targets now set for inflation do not require interest rates to be as high as they have been recently. Interest rates will nonetheless remain high and a tight monetary stance is still being maintained.

All of these are decisions, which hopefully will consolidate the position of Iceland's financial markets, will contribute towards price stability and bolster the foundations for improved living standards.

I would like to end by thanking the government authorities and financial institutions for their pleasant cooperation.