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Ladies and Gentlemen:

I would like to begin by thanking you for the invitation to the Annual Meeting of the Federation of Icelandic Savings Banks. In my speech today I shall discuss a number of issues that involve the Central Bank's tasks and policies in the context of economic developments. I shall also discuss relations with credit institutions, the credit expansion, liquidity rules and interest rate rises, and the part played by the savings banks in the way credit has evolved. Finally, I shall address the development of the Icelandic financial market and the norms and codes applying there.

The Central Bank's objectives

A variety of objectives are laid down for the Central Bank in the legislation governing it. In the course of time they have in effect become simplified, as has been the case elsewhere. Today, the Bank has in principle twin objectives: firstly, promoting low inflation, and secondly, promoting stability in the financial system. In other words, low inflation is the main objective of the Bank's monetary policy, while its intermediate goal is to maintain a stable rate of exchange for the króna against a trade-weighted currency basket. In an open economy like Iceland's, a stable rate of exchange is vital for promoting low inflation. This exchange rate policy has broadly speaking been adhered to since 1989. The króna was devalued towards the end of 1992 and again in mid-1993. Major changes took place in implementation

of exchange rate policy in spring 1993 when an inter-bank foreign exchange market was established and the daily exchange rate began to be determined by market forces. Narrow deviation limits were initially set whereby the króna could fluctuate within a 2¼% band in either direction from the central exchange rate. The band was widened to 6% in either direction in autumn 1995. In practice, the exchange rate policy means that the Central Bank allows the exchange rate to fluctuate within the band, insofar as this serves its objectives of promoting low inflation. At the moment the exchange rate is 3% above the central rate and has been appreciating recently.

In this environment, the Central Bank effectively has only a single instrument, namely the rate of interest, which it can deploy in its transactions with credit institutions. The Bank does not impose quantitative restrictions in its monetary policy, it only employs interest rates. The difference between domestic and foreign short-term interest rates has an impact on currency inflows and outflows, and thus on the exchange rate of the króna. This differential is currently 5.3% .

As you are all aware, the Central Bank changed its monetary instruments early in 1998 to bring them into line with decisions that had already been made for the pending European Central Bank. Since then, Icelandic banks and credit institutions have been in a similar environment to that of comparable institutions in the rest of Europe, apart from the fact that interest rates are much higher in Iceland, for various

reasons which will not be discussed in detail here. The Central Bank's main liquidity provision is through its weekly repo auctions, which until now have been conducted with predetermined interest rates.

Economic upswing

The Icelandic economy has been experiencing a powerful upswing for several years now. This year will be the fourth in a row with a rate of economic growth of 5% or more. Underutilization of the factors of production enabled this growth rate to be sustained for the first part of the upswing. However, it is some time since the Central Bank began to warn that production capacity in the economy was virtually fully utilised and that there was a need to counteract expansionary tendencies. Investment was strong during the first half of the upswing, partly on account of power-intensive development, but private consumption took over afterwards and has been driving growth more recently. The current account deficit has widened. Initially it was linked to imports of investment goods, but is now much more the consequence of consumption-linked imports.

In the current scenario of rising inflation and a sizeable external deficit, it is vital for the treasury to generate a substantial surplus. The draft budget presented to parliament last week entails a considerable surplus, the largest one in many years. In the Central Bank's view, the budget surplus represents tighter restraint than during the present year. Under the prevailing circumstances, it is vital for parliament to pass the budget with at least the surplus assumed in the draft budget. This is necessary not only to secure its economic impact next year, but also to boost public and market confidence in the government's determination to maintain economic stability. Another major point is that pay agreements should be consistent with ongoing stability, which in the long run is the best safeguard for wage earners' living standards. Stability faces risks at the moment, which need to be tackled with every means at our disposal.

Interest rates and credit developments

During the past two years the Central Bank has

raised its interest rates five times: first in November 1997, then in September 1998 and three times this year, in February, June and September. Interest rate rises have a lagged impact on demand for credit but a swift effect on the exchange rate, which then has an impact on domestic prices.

The Central Bank's Autumn Statement published in November 1998 discussed the risk of overheating in the Icelandic economy while also drawing particular attention to the credit expansion and the potential accompanying risks. Attention was also drawn to heavy short-term borrowing by credit institutions in order to fund their growing lending.

Lending by credit institutions began to expand sharply after the middle of 1998. By the end of October last year, credit had grown by 21% over the preceding twelve months and short-term foreign liabilities of credit institutions amounted to almost 36 billion kr.

In part, lending rose on account of growing domestic demand, but there is little doubt that rapidly growing competition among credit institutions was also a factor. New, ambitious players entered the market and the existing ones responded vigorously to this competition. Some of them enjoyed greater lending capacity after share issues, which had boosted their equity.

The Central Bank cautioned against the growth in credit for two reasons. Firstly, it was feeding domestic demand, and secondly, large-scale growth in lending is always accompanied by the risk that credit institutions could become complacent in their risk assessments and sow the seeds of loan losses in later years. It was also apparent that the capital adequacy of many lending institutions was on the thin side, especially after excluding subordinated loans. The experience of other nations can serve as a warning to Iceland in this respect. Suffice it to mention the events in Finland, Norway and Sweden several years ago.

Foreign short-term liabilities

Large-scale foreign short-term borrowing was a particular cause for concern. Foreign current liabilities of the credit institutions amounted to 36 billion kr. at

the end of October 1998. The bulk of this borrowing was for a shorter term than three months. At the end of October 1998 the Central Bank's currency reserves stood at 29 billion kr.

A common feature of the Latin American and Far Eastern countries that ran into economic troubles earlier this decade was that their foreign short-term liabilities had grown excessively and, when confidence in their economic policies failed, their access to short-term foreign borrowing suddenly dried up. Outstanding liabilities naturally had to be paid on maturity, but their central bank currency reserves were inadequate to cover them and these countries' currencies depreciated sharply.

There is no absolute rule about the level of foreign short-term liabilities that can be maintained without entailing risk. However, respected economists have put forward the notion in international circles that vulnerability is invited when the foreign short-term liabilities of a country's credit institutions exceed its central bank's currency reserves.

In the opinion of the Central Bank, foreign short-term liabilities of credit institutions in Iceland were running high enough in autumn 1998 to pose a potential risk not only to the institutions in question but also to the national economy as a whole, the exchange rate and economic stability.

The Central Bank followed up its 1998 Autumn Statement with meetings with representatives of all the main credit institutions, including the savings banks. At these meetings, the Central Bank emphasised the points made in the Autumn Statement, and underlined the importance of cautious lending policies and risk assessments, the risks involved in heavy foreign short-term liabilities and the need to pay careful consideration to capital adequacy. Following these meetings the Central Bank wrote to all major credit institutions in December, reiterating these same points.

By February it was obvious that the Central Bank's warnings had been ignored. Lending growth had continued to accelerate, and foreign short-term liabilities likewise, to end up 10 billion kr. higher at the end of January than at the end of October 1998. In light of this, the Central Bank felt compelled to

raise interest rates and impose a liquidity requirement on credit institutions, which forced them to reduce the weighting of foreign short-term financing of their lending activities.

Liquidity rules

The liquidity rules are prudential in character in the sense that they contribute to more secure funding and ensure that credit institutions always have adequate liquid reserves to meet their obligations. However, it was clear that the new rules would have a restraining effect on lending while the credit institutions were adjusting their activities to them. The rules were harshly criticised by various bankers, for example for disrupting price formation in the domestic financial market and hindering its evolution. Insofar as transactions in the domestic financial market were based on the unrestricted import of foreign short-term capital, the liquidity rules inevitably had a restrictive impact. But the Central Bank was convinced that domestic market trading would grow and flourish once again, and considers that experience has proved this to be the case. Echoes of the criticisms made in the spring still remain, however, and right up to the present day credit institutions have been claiming, for example, that the Central Bank liquidity rules are to blame for the sharp drop in secondary market trading in long-term treasury bonds. This is absolutely wrong; suffice it to point out the very brisk trading in housing bonds which are fully comparable with treasury bonds with respect to the liquidity rules. Trading in treasury bonds had contracted sharply anyway before the liquidity rules were set.

The growth in lending continued to accelerate and no reduction began to emerge in foreign current liabilities until the liquidity rules forced this to happen. As you know, the rules were phased in with increasing force from March to July. Short-term liabilities actually went on increasing until the end of March, when they reached almost 57 billion kr. This trend caused the Central Bank serious concern, not least the apparent lack of appreciation shown by credit institutions regarding the risks involved in using heavy foreign short-term borrowing to finance lending. In the view of the Central Bank, the credit

institutions had been playing brinkmanship to finance their growing lending activities.

The liquidity rules have led to greatly improved liquidity among credit institutions and a reduction in their foreign short-term liabilities. At the end of August they were 15 billion kr. lower than the peak at the end of March, and have probably gone on falling.

New liquidity rules

When setting its liquidity rules last winter, the Central Bank took the initiative of inviting credit institutions and the Financial Supervisory Authority to co-operate in formulating new rules based on more up-to-date perspectives, possibly modelled on those in operation in neighbouring countries. These new rules are virtually finalised and can conceivably go into effect in the New Year. However, they lack legal sanction in the current Central Bank Act. Thus how and when the new rules will be set may depend to some extent on the Bank's authorisation in law. It should also be mentioned that the new liquidity rules are more complex than the existing ones, and may therefore not be suitable for smaller savings banks.

Interest rate adjustments in 1999

The growth in lending in May, June and July was somewhat lower than in the immediately preceding months. Nonetheless, rising inflation led the Central Bank to put up its interest rate in June. In connection with the interest rate rise in February, the Central Bank implied that it would prefer to strengthen foreign currency reserves rather than allow the króna to appreciate, and reserves grew considerably afterwards. In June, however, growing inflation led the Bank to decide to allow the króna to appreciate rather than strengthening the currency reserves, given the rapid impact that import prices have on domestic prices. The Bank implied the same when interest rates were adjusted in September. The króna has appreciated by just over 2% since June.

The September rise in interest rates followed a 0.8% increase in prices at the beginning of that month compared with the beginning of August. In addition to this exceptionally large rise in inflation,

growth in lending by deposit money banks showed a disappointing increase once again in August. There are indications, however, that little growth took place in lending by the commercial banks and savings banks in September.

Lending developments and bank equity

By the end of August, lending by deposit money banks had grown by 16.6% from the beginning of 1999, and by 34% over the preceding twelve months. Lending by the savings banks, including Icebank, rose over the same periods by 22% and 41% respectively, or considerably more than the average for deposit money banks as a whole. In August alone, the savings banks' lending grew by 4.4%, but that of the whole sector by 2.3%. Bearing in mind that the savings banks and Icebank accounted for 23.3% of total lending at the end of August, it is obvious that their large-scale increase in lending has played a major part in the credit expansion.

In the recent term the savings banks' equity ratios have been falling rapidly. I therefore see grounds for seriously urging the savings banks, and in fact credit institutions in general, to slow down their lending sharply, and exercise the utmost caution in their lending activities. It is vital to consider the security of loans, to corporate and private borrowers alike. Eventually economic activity will contract and the position of businesses and households will become tighter. Collection of outstanding loans will become correspondingly more difficult. If full caution is not exercised now, it is likely that the savings banks and other credit institutions will suffer loan losses in the next few years, with a resulting drop in their profitability. Given the need for solid equity during tighter periods, I also urge the savings banks and other credit institutions to pay close attention to their equity position and ensure that it is firm enough to enable them to tackle tougher times without jeopardising their financial position.

Financial system stability and the domestic financial market

As I mentioned at the outset, one of the Central Bank's two main objectives is to ensure security in

the financial system. After the Bank Inspectorate was transferred from the Central Bank, the bank has been organising its tasks that concern financial system stability. The Bank also co-operates closely with the Financial Supervisory Authority and care is taken to ensure that there is no duplication of tasks. Although I shall not go into these tasks in detail here, I cannot fail to address a limited but important aspect of the domestic financial market.

The domestic financial market has evolved very rapidly in recent years. Of course you are well aware of this, since the savings banks have been active participants in this development. New players have emerged, so have new investment options, and last but not least the domestic equity market has been evolving very quickly. A framework has been created for these transactions which in the main is based on European Union laws and regulations. In such an environment it is vital to adhere in all respects to the rules that are in effect, and to make trading transparent in order to ensure that all investors have equal access to information which could influence assessments of their assets or investment plans. To ensure that all domestic market players abide by the trading rules, the supervisory institutions which we have established must have legislation that enables them to effectively perform their role. At the same time, market players, investors and others, must assume the accompanying responsibility. Otherwise, there is a risk that all this development work will have been done in vain, and that trading practices and an environment will evolve which repel professional investors, domestic and foreign alike. This is not least a point to ponder when the privatisation of valuable state assets is in progress. Transparency must prevail and investors must adhere to the set rules on equity market trading.

Alongside the need for transparency and equal access to the same information that could affect securities assessments, it must be underlined that firm

action must be taken against investors who take advantage of inside information in their share buying or selling decisions. In this context I remind you that norms and codes are clearest in countries with the most advanced financial markets, and more stringent demands are made there concerning the conduct of market players. They also impose some of the toughest penalties against infringements of the rules. I am pointing this out here because the savings banks and their companies have been party to large-scale transactions in the equities market and have been criticised for the way they have managed them. Public organisations such as savings banks are highly dependent on maintaining public confidence and respect, and should set an example regarding respect for natural or obvious rules of the game in financial markets.

Conclusion

Ladies and Gentlemen:

The Central Bank has been implementing a policy of monetary restraint in the recent term. One reflection of this policy is the large differential between domestic and international interest rates. The Bank has stated that it will continue to pursue a policy of restraint, given the urgency of reducing inflation and returning to the price stability we have experienced in recent years.

To conclude, I shall repeat my earlier observation that the savings banks accounted for over 23% of total lending by deposit money banks at the end of August. This shows how important the savings banks are on the Icelandic financial scene. I wish the management of the savings banks every success in their important work and hope for continuing good co-operation between the savings banks and the Central Bank.