Address

By Birgir Ísleifur Gunnarsson, Chairman of the Board of Governors,
Central Bank of Iceland,
at the Bank's annual meeting,
March 23, 2004

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 43rd annual meeting. The Bank's financial statements for the year 2003 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 performance, along with a detailed 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.

Price developments

Three years have now passed since Iceland's monetary policy framework was changed and a formal inflation target was adopted with a joint declaration by the Government and the Central Bank. Under this framework, the target of monetary policy is price stability. The Central Bank is obliged to aim at an average rate of inflation, measured as the annual 12-month increase in the CPI, of as close to 2½% as possible. Since monetary policy aims at maintaining price stability, it will not be applied to achieve other economic targets such as a balanced current account or a high level of employment, except insofar as these are compatible with the Bank's inflation target.

Prices were stable in 2003. Over the year, i.e. from the beginning of January 2003 to the corresponding period in 2004, inflation measured 2.4%. This is just below the target. Excluding changes in the price of public services, the rate of inflation was somewhat lower. Until the closing months of 2003, goods prices were somewhat lower than the previous year, and the increase in prices of services slowed down significantly. Substantial increases were seen in housing prices, however, and the housing component of the consumer price index rose by much more than the CPI as a whole. Housing inflation began to inch downwards in the course of the year and this development has continued so far this year. The Central Bank can thus feel satisfied with the rate of inflation in the recent term, and bearing in mind the long lag in the transmission mechanism, price developments indicate that monetary policy over the preceding period has had the intended effect.

The Central Bank lowered its policy interest rate to 5.3% in the beginning of February 2003. Its inflation forecasts did not warrant any further changes in the policy rate by the Bank. The policy rate was broadly neutral during the year, i.e. it neither stimulated nor dampened demand. In real terms the policy rate was therefore not far from the estimated equilibrium real interest rate during the year.

Output growth

Iceland experienced robust output growth from 1996 until 2002, when it was marginally negative. Output growth recovered last year. Latest estimates from Statistics Iceland put the figure at 4%, which is somewhat higher than the Central Bank assumed in its updated macroeconomic forecast published earlier this month. Statistical evaluation of output growth in 2003 could still change when estimates are revised, which illustrates the uncertainty that surrounds recent and current economic developments and compounds the uncertainty about the future that monetary policy formulation always faces. Be that as it may, output growth was clearly robust and is explained above all by a rapid increase in national expenditure after two years of contraction. Private consumption growth also picked up and investment soared after a sharp recession, primarily due to the impact of the hydropower and aluminium projects that were launched during the year, along with investment in housing.

An interesting comparison can be made between output growth in Iceland and other countries, especially the euro area which is often used as a frame of reference. Roughly speaking, from 1996 to 2001 growth in Iceland was two to three times higher than in the euro area. In 2002 the euro area performed better, but in 2003 growth was estimated at 0.8% in the euro area while it was 4% in Iceland. The difference is even more pronounced between Iceland and the largest euro countries, Germany, France and Italy, whose economies have been sluggish for several years. This large difference in growth explains much of the interest-rate differential that has prevailed between Iceland and that area. In part the policy stance of the European Central Bank has to the extent possible been guided by efforts to drive growth with low interest rates, while the Central Bank of Iceland's objective has by and large been to contain economic overheating.

The current account deficit and the labour market

Iceland's external balance has been volatile in recent years. A current account deficit equivalent to 10% of GDP in 2000 was virtually eliminated within two years, but widened sharply again in 2003. After reasonable balance in the first quarter and a sizeable merchandise account surplus, the deficit in the second and third quarters was the largest since the beginning of 2001. For the year as a whole, the current account deficit was equivalent to 5½% of GDP. A recession in exports was a strong contributing factor, along with rising imports driven by private consumption, but much of the widening current account deficit may be ascribed to imports of investment goods for a hydropower project. In this respect the deficit is benign in origin, although the pace of increase so early on in the upswing is a cause of some concern.

As is commonly the case at the onset of a growth episode, the increase in demand for labour was fairly slow during the year. The unemployment rate came down more slowly than had widely been expected given the surge in vacancies registered with employment agencies. Seasonally adjusted unemployment began to decline slowly from the autumn onwards. On the other hand, the number of vacancies doubled last year and demand for foreign labour picked up as the year wore on. In February 2004, seasonally adjusted unemployment was 2.9% and had gone down by 0.1% per month since September 2003. Productivity growth appears to have been exceptionally high last year. As in recent years, domestic wage rises outstripped those among Iceland's main trading partner countries. Measured by the wage index, domestic wages rose by 5½% in 2003, which represents 3½% growth in real terms.

Exchange rate developments and foreign reserves

Under the new monetary framework, Iceland abandoned a fixed exchange rate regime and the króna was floated in the market. Every so often the argument is put forward that the Central Bank can determine the exchange rate, and some people criticise it if the exchange rate develops along different lines from what they had expected. Such debate was far less prominent in 2003 than the year before, which definitely indicates a growing awareness that the Central Bank cannot exert a decisive impact on the exchange rate of the króna. For the first part of the year the króna strengthened, probably as the result of expectations of currency inflows in connection with investments in hydropower and aluminium. Around the middle of the year the króna depreciated again. Uncertainty about revenues from the Keflavík NATO base and about the Norðurál aluminium smelter expansion, and perhaps to some extent stepped-up Central Bank currency purchases, are probable explanations. Around the same time, currency inflows diminished in connection with credit movements. The króna began to appreciate again in September, around the time of reports that the Norðurál expansion looked more likely to go ahead and less uncertainty about operation of the NATO base. Currency inflows and outflows were in fairly good balance during the last months of 2003 and the exchange rate settled down. Towards the end of the year the króna began strengthening again, until mid-January. The main explanation for this appreciation is probably inflows of borrowed funds in connection with a series of business mergers and takeovers.

Changes in the exchange rate of the króna need to be examined in the context of the slide of the US dollar against the euro. One consequence has been that the exchange rate of the króna against the euro is roughly the same now as it was two years ago, while the dollar has weakened against the króna by one-third over the same period.

By law, one of the tasks of the Central Bank of Iceland is to maintain foreign exchange reserves in accordance with its objectives and role. At the end of 2001 the foreign reserves were largely sustained with foreign borrowing by the Central Bank, which left the external position unacceptably low on a long-term view. The reason was that under the fixed exchange rate regime, the Central Bank frequently intervened in the FX market in 2000 and 2001 by selling foreign currency in an effort to stem the slide of the króna. In 2002 the Central Bank began building up its foreign reserves again, purchasing foreign currency for the equivalent of 4.5 b.kr. Last year the Bank stepped up these purchases to the equivalent of 43.2 b.kr. Nonetheless, the Bank's purchases only amounted to 3.6% of total turnover in the FX market during the year. By mid-2003 the Central Bank had repaid its foreign short-term borrowing in full and at the end of the year the foreign reserves amounted to more than 58 b.kr. This year the Bank has continued to purchase currency in the market, but on a smaller scale than in 2003. It thereby aims to strengthen its foreign reserves even more this year. Ample foreign reserves are an obvious prudential measure and one of the factors that international ratings agencies consider when evaluating the creditworthiness of Iceland's sovereign and corporate debt. However, a high level of reserves does leave the Central Bank's operations much more exposed to changes in the exchange rate, as reflected in the minor operating loss reported for last year, which was described earlier at this meeting.

Financial stability

The Central Bank is obliged by law to promote price stability and also an efficient and safe financial system, including payment systems domestically and with foreign countries. In most countries these are the main objectives of central banks. This role is important because shocks to the banking and financial system are closely linked to changes in the value of financial assets, interest rates and the exchange rate. The Central Bank's monetary policy measures and information systems enable it to evaluate the risk of financial shocks and warn against them.

The Central Bank published two reports on financial stability in *Monetary Bulletin* last year, in May and November. The broad finding was that the position of the financial system strengthened during the year, and a new report published last week indicates that the position of major financial companies and markets is relatively firm. Macroeconomic conditions are favourable on the whole. The main concerns are the expansion in largely foreign-financed lending, and high asset prices. There has been a noteworthy flurry of leveraged buyouts of listed and unlisted companies, which provide one explanation for the surge in lending by banks. These transactions have driven up equity prices of several listed companies, including financial companies, prompting the question of what the impact will be should share prices head back down. Housing prices in real terms have stopped climbing in the Greater Reykjavík Area, for the time being at least, but a substantial drop is unlikely in the near future. Asset price developments are an important factor for financial stability assessments and may also influence monetary developments, especially in an economic climate such as the present. A decline in equity and housing prices could serve to counter potential overheating of the economy in the next few years. The main shock to financial stability and monetary policy would be if asset prices were to drop sharply at the same time as the growth of real disposable income slows down at the end of the aluminium-related investment boom.

Lending developments

As I mentioned before, lending growth is a cause for concern, both for financial stability and the Central Bank's inflation target. Domestic lending grew at a brisk pace in 2003 and this development appears to be heading in the same direction this year. Total domestic lending by deposit money banks over the twelve months to the end of January increased by about 23%, which is above a rate consistent with long-term price stability and economic stability. The period 1998 to 2001 provides a recent example of the consequences of heavy credit growth. Both arrears and loan losses rose in the wake of the credit boom, leading to a temporary tightening of the commercial banks' and savings banks' foreign funding. While the recession and the ensuing strain on the financial system are now over, it can be partly ascribed to relatively favourable economic conditions and the consequently sharp turnaround in the exchange rate of the króna that financial companies only sustained minor setbacks.

Proportionally, the highest growth in deposit money banks' lending has been to foreign borrowers, but foreign currency-denominated lending to domestic entities has also surged, by more than 45% over the past 12 months. By no means all this foreign currency-denominated credit has been provided to domestic businesses and households that have foreign currency income or other hedges against exchange risk. This poses a particular risk for borrowers and lenders alike.

Foreign debt of deposit money banks at the end of January 2004 had risen year-on-year by almost 300 b.kr., or two-thirds. There are probably a number of explanations for this strong demand for foreign borrowing. Firstly, it is connected with changes in Icelandic business structures and ownership. Following the privatisation of state banks, investors have been actively involved in dissolving the old links in business ownership and forging new ones. Foreign funding, mediated by the banks, has played a key role in these events. Secondly, conditions in international finance markets have been favourable for such reshuffling. Foreign short-term interest rates are close to a historical low and foreign long-term interest rates are still very low, although they have risen above the nadir they reached around the middle of last year. Thirdly, Iceland enjoys economic stability and growth prospects are favourable for the next few years.

In December last year the Central Bank sent a letter to chief executives of the commercial banks and largest savings bank expressing concern about the rapid increase in lending and high levels of foreign short-term financing. As is generally the case people responded in different ways, and some pointed the finger elsewhere. An encouraging aspect of subsequent developments, however, is that the banks have begun to extend the maturities of their foreign borrowing, so that the gap between their short-term and long-term liabilities has narrowed in recent weeks. This is crucial, because it may be imprudent to place excessive faith in the availability of short-term funding. In its letter, the Central Bank echoed cautionary remarks from the agencies that award credit ratings to the Republic of Iceland and other Icelandic borrowers in foreign markets. Ratings agencies have stated that their chief concern and the main constraint on upgrading Icelandic ratings – or even a potential reason for downgrading them – is the high external debt position of the economy. Since the Treasury has been retiring its foreign debt over the past few years, the ratings agencies' comments are addressed elsewhere, in particular to the banks. Cautionary remarks based on such arguments should of course be heeded by all the banks in Iceland that have been borrowing abroad recently. It is in everyone's interest to safeguard Iceland's credit ratings and, where possible, strengthen them.

Payment and settlement systems

At the Central Bank's annual meetings in recent years I have outlined the work it has undertaken in development of payment and settlement systems. Two types of payment system are in operation in Iceland, both of them settlement systems, i.e. the Central Bank's real-time gross settlement system and the netting system operated by Fjölgreiðslumiðlun hf. Settlements of securities transactions are processed by the former system. Participants are the commercial banks, savings banks and Central Bank. The Icelandic Banks' Data Centre provides software services for both systems and the Central Bank acts as a settlement provider. These systems are described in detail in the Central Bank's annual report.

Since 2001, the Central Bank has been working in close collaboration with Fjölgreiðslumiðlun, the Icelandic Banks' Data Centre and credit institutions on development of payment systems with the aim of bringing them into compliance with the BIS Ten Core Principles for Systemically Important Payment Systems. This work has focused on clarifying the qualifications and responsibility of management and netting system participants. Settlement processes have been reviewed with respect to finality of payments and timing of settlements. Risk management has been strengthened by defining and monitoring risks, making debt positions visible, restricting debt positions and requiring collateral for settlements. Arrangements for oversight, communication of information and contingency plans have also been reviewed.

An important landmark in the development of these systems was reached last year when two sets of rules were adopted, on the Central Bank of Iceland's real-time gross settlement system and on activities of netting systems. At the end of the year the systems were designated and notified to the EFTA Surveillance Authority. The real-time gross settlement system and netting system have thereby been recognised as legitimate payment systems in Iceland and across the European Economic Area. Also in 2003, the Central Bank and FME [Financial Supervisory Authority] signed a cooperation agreement on oversight and prudential supervision of payment and settlement systems. I would like to express my special thanks for the good cooperation with all parties involved on these important issues. Even though important milestones have been attained, sound operation of payment systems will remain an important and extensive task.

A multicurrency country?

Every so often the question has cropped up of whether Iceland is destined to become what has sometimes been called a multicurrency country. This apparently refers to when a large share of business transactions are conducted in more than one currency and liabilities of various kinds are mostly denominated in foreign currencies. Indications that have been cited include performance-related wages in the fisheries sector, which represent indirect indexation of wages to the exchange rate; an increasing trend for corporate accounting to be conducted in foreign currencies; and the fact that recently even households have been offered foreign currency-denominated loans. Other factors mentioned have been greater globalisation, the growing importance of external trade, and of foreign investment.

There is a tendency to paint a rather exaggerated picture of Iceland's dependence on global trade. Admittedly, foreign trade has been on the increase, but is still quite small relative to the size of the economy. Direct foreign investment is proportionally much lower than in most advanced economies, while the scope of foreign indirect investment is similar to that in neighbouring countries. Foreign currency deposits are an established feature of the banking system in Iceland. They are well within the reference limits that the IMF, for example, applies in classifying countries according to whether the use of foreign currencies is important for them or not. Accounting in foreign currencies is confined to a handful of companies with multinational operations and generally speaking the króna is overwhelmingly predominant. However, it is true that among the advanced economies, Iceland has one of the highest levels of external debt and exchange-rate sensitivity.

Bearing all this in mind, there is hardly any question about the solid position of the króna in the Icelandic economy. Nothing gives us any reason to expect that to change. As in other countries that earn considerable revenues from tourism, foreign currencies are always used to some extent, but this is probably a much more common practice in countries with long borders with other currency areas, such as Canada or Switzerland. It seems highly unlikely that the króna's position as a trading currency would be so severely undermined that other currencies would be preferred in domestic transactions. Continual movements in the exchange rate of the króna would create a broad risk in using other currencies, unless all liabilities – and that includes wage settlements – were to be converted into the same foreign currency at virtually the same time. Because it is more economical for business transactions and liabilities to be denominated as far as possible in the same currency, a fundamental change in the position of the króna is unlikely, except directly by an act of government, or indirectly in the highly improbable event that economic policies were to collapse and erode all confidence in the króna, with accompanying hyperinflation, as has happened in some Latin American countries that have adopted the dollar or others that have been forced to adopt another currency.

It has sometimes been claimed that the heavy level of external debt means that interest rate decisions by the European Central Bank possibly have even more impact in Iceland than domestic monetary policy. There is nothing new about the impact of foreign interest rate developments being felt in Iceland – and the same applies to other countries as well – although the scale of Iceland's foreign debt leaves its economy more susceptible to foreign interest rate movements. It is worth remembering that while foreign interest rate developments mostly affect Iceland's national income, economic cycle and current account balance, they can never have a crucial impact on the domestic rate of inflation. A heavy weight of foreign currency-denominated borrowing in domestic debt may complicate the transmission mechanism of monetary policy. In the long run, however, only domestic monetary policy measures can determine a deteriorating value of the domestic currency vis-à-vis goods and services – or to put it plainly, inflation.

Prospects

Finally, I shall turn to economic and monetary prospects. Last week the Central Bank published its quarterly *Monetary Bulletin*, which included an updated macroeconomic and inflation forecast. This is not a comprehensive new forecast, which henceforth is scheduled to be published twice a year, in June and December. Inflation is now forecast to remain below the target until the second half of 2005. Around that time it can be expected to rise above the target, on the assumption that the exchange rate and the Central Bank's policy interest rate remain unchanged. In assessing price developments and the inflation outlook it is important to bear in mind that the recent strength of the króna has probably been unsustainable in the long run. Recent price developments and forecasts based on the assumption that the króna will remain strong may therefore underestimate latent inflationary pressures. Capital inflows over the next two years may bolster the króna, but this cannot be taken for granted given that conditions could change.

A sizeable increase in productivity last year appears to have contributed to the recent low rate of inflation, despite higher output growth in 2003 than forecast in November. If productivity continues to grow at an unusually brisk pace, it will ease inflationary pressures in the near term. The recently concluded wage settlements, which broadly speaking seem compatible with the inflation target, include provisions that could induce greater efficiency in business operations and boost productivity. Another recent factor that has served to ease inflationary pressures is that rapid growth in national expenditure has primarily been channelled into increased imports. It has therefore exerted less pressure on domestic factors of production than otherwise, but is reflected in a widening current account deficit, as I have discussed. In the long run, an excessive current account deficit could undermine the exchange rate and fuel inflation, although this does not appear to be much of a threat within the horizon of the latest forecast.

The Bank's macroeconomic forecast now assumes that the Norðurál aluminium smelter expansion will go ahead, which raises projected output growth to 3½% in 2004 and 4½% in 2005. The appreciation of the króna, strong increase in productivity in 2003 and large share of foreign labour employed on hydropower and aluminium projects will result in less pressure on domestic factors of production and prices than would otherwise be the case.

As I mentioned earlier, it is likely that some of the appreciation of the króna in the first half of last year was connected with planned investments in aluminium and hydropower projects. Had these plans not materialised, it is almost certain that the Central Bank's policy rate would be lower today. Due to the strengthening of the króna in 2003 and the proposed tightening of the fiscal stance implied by the budget for this year, the Central Bank's policy interest rate has remained unchanged since February last year. The Central Bank does not consider that there are grounds for raising the policy rate yet, but all things being equal the inflation forecast calls for a higher policy rate in the coming months, even though the inflation outlook is favourable until some time next year. Because monetary policy needs to be forward-looking, this could well mean that the Central Bank will raise its interest rate even though inflation is still below the target. Large-scale investments over the next few years mean that monetary decisions need to take into account a longer horizon than usual. Considerations of financial stability call for the same approach.

Ladies and Gentlemen:
Inflation forecasts play a key role in the Central Bank's monetary policy decisions. Looking into the future is always difficult, but I think that the Central Bank can feel satisfied with how accurate its inflation forecasts have turned out to be.

I would like to conclude by thanking the Office of the Prime Minister and other government authorities for their pleasant cooperation. I also thank the financial institutions for their good collaboration. Last but not least, I would like to thank the employees of the Central Bank for their fine work, without which the Bank could not have achieved such impressive results.