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Address to the Annual Meeting, March 29, 2000¹

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 39th annual meeting. The Bank's financial statements for the year 1999 have been ratified today by the Prime Minister. This is the first time that this arrangement has been followed, after an amendment to the Central Bank Act at the beginning of the year which transferred authority for the Bank to the Prime Minister from the Minister of Commerce. 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 operations, the financial system and financial markets, and the main characteristics of economic developments in the course of last year. I shall now address several aspects of economic issues and present prospects, in particular those most closely connected with the Central Bank's field of activities.

Inflation

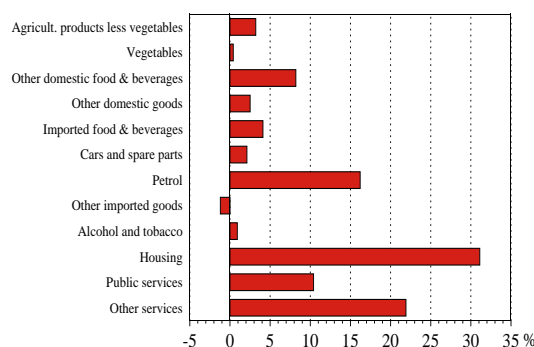
Last year the Central Bank focused increasingly on the signs of overheating that characterised economic developments. In fact, clear indications of overheating had already emerged during the previous year, mainly taking the form of a large current account deficit and growing pressure in the labour market. Last year, these factors were compounded by rising inflation, which is now much higher than among any of Iceland's main trading partners. The consumer price index rose by 5.8% in 1999, which is the highest annual rate of inflation since 1991. Just under one

percentage point of the annual inflation figure may be attributed to rises in petrol prices in foreign markets and just under one-third of the total to rises in the price of residential accommodation in the Greater Reykjavík Area, which is still the only part of the country included in this index component. Thus the combined rises in petrol and housing prices explain just under half of last year's inflation. These qualifications, however, need to be seen in light of the fact that the rise in housing prices is primarily a sign of high domestic demand, and also that other countries have had to put up with large increases in petrol prices without substantial inflation resulting from them.

The development of domestic and foreign food prices also contributed to the rise in the inflation rate. Domestic food, excluding agricultural products, rose by 7.4% last year. Imported food and beverages went up even more, or by 7.8%, despite the appreciation of

Chart 1

Analysis of CPI inflation in 1999 (%)



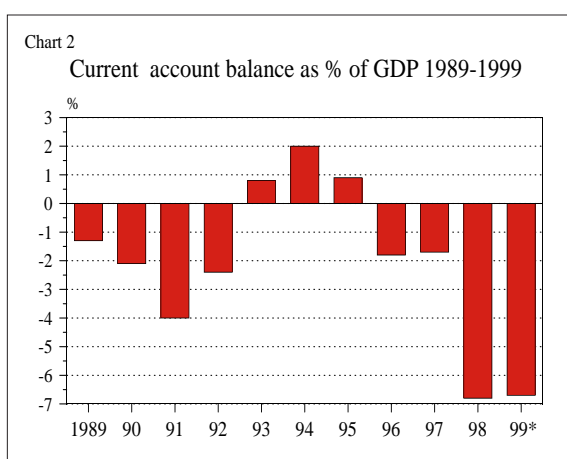
1. Translated from Icelandic.

the króna. However, food prices remained constant in the euro countries. In the USA and Scandinavia they kept pace with the general consumer price trend, but they fell in the UK. All this suggests that high demand and diminishing competition explain the large rise in food prices in Iceland.

The Central Bank publishes its inflation forecast four times a year. The rise in inflation in 1999 significantly exceeded forecasts. In its most recent inflation forecast this January, the Central Bank assumed that prices would rise by 5% between 1999 and 2000 and by 3.8% from the beginning to the end of 2000. Measurements in February and March suggested marginally higher inflation than had been forecast, offset by a somewhat higher exchange rate. It is not least higher housing costs that have caused the rise in the price index. However, pay agreements have now been signed covering a sizeable part of the labour market which in principle appear to be compatible with the wage rise assumptions on which the Central Bank's January forecast was based. Thus inflation could end up lower this year than last, and it is important that everyone capable of contributing to this trend should act accordingly.

Current account deficit

For the second consecutive year, the current account deficit was unacceptably high, at 42.8 b. kr., which is equivalent to 6.7% GDP. This is a similar deficit to that of the preceding year. It is not only the deficit



itself which gives cause for concern, but also the fact that it originates to a growing extent in private consumption rather than capital formation. Private consumption was partly funded by credit, and the ratio of household debt to disposable income rose considerably in the course of the year. The National Economic Institute assumes a large and growing current account deficit this year, equivalent to 7.2% of GDP, which will persist for the next few years. It is necessary for economic policy to aim towards containing the current account deficit.

Economic growth

Substantial economic growth was achieved in 1999 for the fourth consecutive year, at almost 4½%. Such a sustained period of dynamic economic growth is unique among the industrial countries. Growth has also been running high in the USA, in fact, and is estimated at 4% last year. In the euro countries it is estimated at 2.2%, in the UK 1.9% and in Japan 0.7%.

Over this four-year period, the nature of economic growth in Iceland has changed. For the first part of the period it was driven by heavy investment, but this contracted in 1999. Growth in private consumption remained strong, however. The main stimuli have been considerable increases in real disposable income, a higher level of employment, tax reductions and large-scale credit expansion. Strong economic growth is still being forecast in Iceland for the current year, at 3.9%. The same applies to the USA, while economic growth in the euro countries is expected to exceed 3%.

The labour market and industrial profitability

Other clear signs of overheating emerged in the labour market. Unemployment averaged 1.9% last year, the lowest level since 1991. It is forecast to drop to 1.7% during the present year. On the other hand, labour market surveys reveal differences between the Greater Reykjavík Area and regional parts of Iceland. There was a pronounced shortage of manpower in various fields in and around the capital, but a tendency to cut back on staff in the regions. An

influx of foreign workers reduced the labour shortage, with almost three thousand work permits issued during the year compared with less than twelve hundred in 1996, when a strong influx of Icelandic nationals took place. Net immigration to Iceland by people of working age amounted to 773. This was the second consecutive year of net immigration, while net emigration was generally the case during the preceding decade. These facts, coupled with high contractual pay rises, led to less wage drift than might otherwise have been expected.

The real exchange rate of the króna rose somewhat, since domestic prices and wage costs increased by considerably more than among main trading partner countries. Tight money also led to an appreciation of the nominal exchange rate. All things being equal, such a trend causes a deterioration in the competitive position of export and import-competing industries. Nonetheless, the real exchange rate during the last quarter of 1999 was close to the average for the past 20 years and a long way below the peak that it reached in 1987 and 1988. Overall industrial profitability was good, and it is interesting to note that exports of manufactured goods, from both power-intensive industries and other branches of industry, showed a marked increase during the year.

There are no grounds for supposing that the appreciation in the real exchange rate was too great to be compatible with long-term stability. For as long as the impact of tighter monetary and fiscal restraint

has not been fully delivered in the form of better economic equilibrium, industries will inevitably have to accept a poorer competitive position for the time being, and even a higher real rate of exchange than at present.

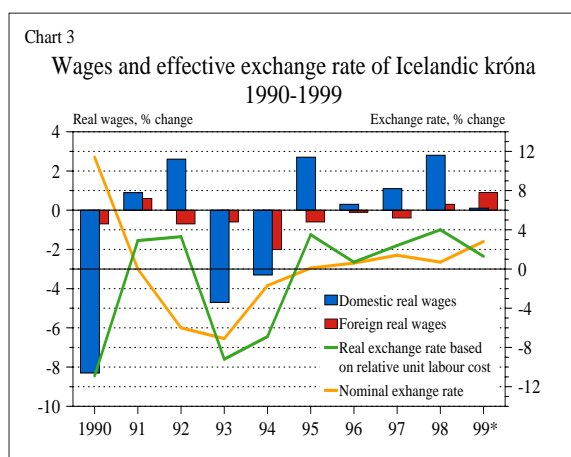
Government finances

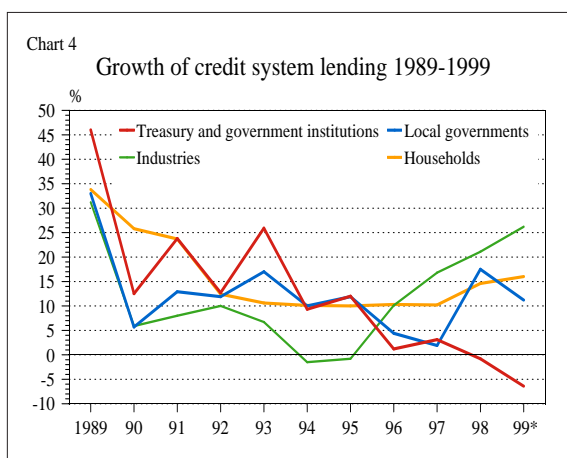
I shall now devote a few words to central government finances, which are inevitably given a strong focus in the battle against the current account deficit. Central government finances were in a strong position during the year, above all as a result of large economic growth. Sale of assets also played some part, and all things being equal they should serve to dampen overheating. Central Bank measurements suggest that fiscal impact was eased during 1999. The position of local government authorities remained difficult, apparently producing an operating deficit of just over 3 b. kr. as against 4.3 b. kr. the previous year. It is fair to say that the degree of restraint applied to government operations as a whole was inadequate, given the overheating that prevailed in the economy. This year it is planned to tighten fiscal restraint with a 16.7 m. kr. budget surplus. It is vital not to exceed the outlay targets in the budget, and to allow any conceivable surplus revenues to be delivered in full in the form of a greater treasury surplus. In the present highly expansionary climate, the treasury is the most powerful tool for contributing to better macroeconomic balance.

Credit expansion

One of the main characteristics of 1999 was rapid expansion in credit and money supply. Lending by the credit system as a whole increased by 17.4% during the year, and lending by deposit money banks by even more, or 23.1%. Base money (M3) increased by 17.1%. Around the middle of the year this growth was running even higher, but decelerated in the second half of the year. More than half of the credit growth was financed by foreign borrowing.

Rapid growth in lending by DMBs can be attributed to both high demand and greater supply of credit. One form taken by increased supply was the





efforts made by DMBs to capture a larger market share. The commercial banks and savings banks' balance sheets grew significantly, and their equity ratio excluding subordinated loans dropped overall, although the extent varied from one institution to another. This happened in spite of very good profitability among DMBs during the year. The Central Bank reiterates its view that credit institutions ought to take advantage of favourable operating conditions to build up a strong equity position, in order to equip themselves better for more difficult times. In some cases at least, the intense credit growth of the past two years prevented this from being done.

Since the growth in domestic demand was driven by borrowing to a significant extent, there was an increase in corporate and household indebtedness in 1999. According to provisional figures, households increased their debt by 71 b. kr. to account for 147% of their estimated disposable income last year. Household debt was equivalent to 72% of disposable income a decade ago, and only one-fifth two decades back. Corporate lending by the credit system increased by 26%. Indebtedness grew in particular among companies in commerce and services, by almost three-quarters. A considerable proportion of that debt was reliant foreign credit and thus denominated in foreign currency.

Central Bank policy and actions

I shall now turn to the Central Bank's monetary pol-

icy and actions. On account of the expansionary characteristics in the economy, the Bank followed a very tight policy. It raised its interest rates three times during the year, in February, June and September, by a total of 1.5 percentage points. In spite of these rises, the Bank's policy rates hardly managed to keep pace with changes in inflationary expectations. Since the New Year the Central Bank has raised its interest rates twice, by a total of 1.1%. Under the prevailing economic conditions, the Central Bank will implement a policy of tight monetary restraint.

Early in 1999 the Central Bank set new liquidity rules to counteract the deteriorating liquidity position of credit institutions and greater use of foreign short-term capital. The liquidity rules served their intended purpose, and in the short run at least seem to have contributed to a deceleration in lending growth among credit institutions.

The liquidity rules aimed to contribute towards the operational security of credit institutions rather than to serve as a monetary instrument. However, given the institutions' poor liquidity position, the Bank expected its new rules to dampen credit growth while they were adjusting to them. The Central Bank was well aware that these rules would have various side-effects, some of which were undesirable. In cooperation with the credit institutions, the Bank then formulated new rules on liquidity ratios which went into effect at the end of last year.

After the Bank's reform of its monetary instruments in 1998, its liquidity transactions with DMBs now largely take the form of security repurchase agreements. The Bank conducts weekly auctions at which it offers fourteen-day loans to credit institutions at fixed interest rates determined by the Bank itself. Central Bank repo trading increased sharply in the closing months of last year. The reason lies in fluctuations in the DMBs' liquidity position, which are generally the result of seasonal fluctuations in the treasury's position with the Central Bank and seasonal currency outflows. Privatisation of state assets also exerted some impact on the liquidity position of commercial banks and savings banks towards the end of last year.

The large growth in Central Bank repurchase agreements with credit institutions has prompted speculation as to whether this is not in fact the explanation for the large expansion in credit and money supply, and whether the Central Bank would not be justified in restricting the supply of such agreements with the aim of curbing money supply growth and the credit institutions' lending capacity.

Most central banks in the industrial countries have opted to manage interest rates rather than supply. There are several reasons. Firstly, quantitative controls lead to greater fluctuations in interest rates in the money markets, which can create uncertainty about the real degree of restraint that the Central Bank is actually aiming for. In other words, monetary policy becomes less clear. Secondly, restrictions on credit supply can exacerbate the liquidity problems of individual credit institutions and lead to systemic problems. Thirdly, quantitative controls are difficult to apply in an open economy which has unrestricted capital movements with other countries. This can lead to undesirable fluctuations in the exchange rate.

For these reasons, the Central Bank does not control base money any more than central banks in neighbouring countries do. Money market interest rates are the Bank's main instrument, given that it is impossible to manage both price and quantity. The experience of 1999 showed that the Central Bank's changes in its interest rates had a swift impact on other unindexed interest rates in the money and credit markets.

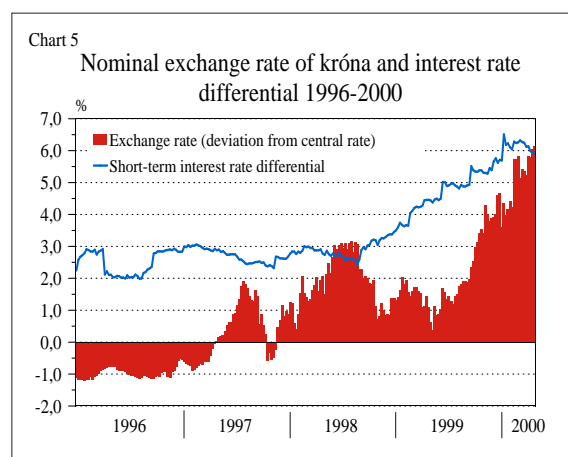
Foreign exchange

The Central Bank's interest rate decisions have an impact on the differential between short-term interest rates in Iceland and abroad. The differential on three-month T-bills was 3.5% (trade weighted foreign rates) at the beginning of 1999, but 5.7% towards the end of the year. At the moment, the trade-weighted differential in interest rates between Iceland and abroad is 6.25%, measured by the same criteria.

The wider interest rate differential contributed to capital inflow. According to Central Bank estimates, the capital account was in surplus by 58 b. kr. last

year. The capital inflow is largely the result of foreign borrowing by credit institutions and corporations, while a considerable outflow took place on account of foreign indirect investment by Icelanders and a rise in their deposits abroad. The greater inflow contributed to an appreciation of the króna, which is determined in the interbank foreign exchange market. The króna appreciated by 2.72% in the course of 1999. At the beginning of the year the exchange rate was 1.6% above the central rate, but it had reached 4.32% by the end of the year. The króna has continued to strengthen so far this year and is presently 5.4% above the central rate, having appreciated by more than 1% this year. There is no doubt that the inflation rate would have been higher now had the Central Bank not acted to strengthen the exchange rate. As a rule of thumb, for each percentage point that the exchange rate appreciates, inflation is reduced by 0.4%.

In an open economy like Iceland's, a close relationship exists between the exchange rate and price level. Thus exchange rate stability has been an intermediate aim of monetary policy, and the Central Bank has used interest rates as an instrument to keep the exchange rate of the króna within a specified range. After the establishment of the interbank foreign exchange market the fluctuation band for the currency index was initially set at 2¼% in either direction from a central rate, and in 1995 this was extended to 6%. At the beginning of this year the



band was beginning to restrict what the Bank saw as a desirable exchange rate movement for keeping the rising inflation rate in check. Accordingly, the Central Bank asked the government to extend the band by 3 percentage points in either direction, to create more scope for monetary restraint. This reform was implemented on February 14 and the currency fluctuation band is now 9% in either direction. At the same time, the Bank raised its interest rates by 0.3%. The interest rate rise had a twin purpose: to respond to interest rate rises which had taken place overseas in January and February, which had narrowed the differential in money market interest rates between Iceland and abroad, and also to relay a clear message about monetary restraint and a stronger exchange rate. These decisions were well received in the markets and have served to strengthen the króna even further.

Since its establishment in 1993, the interbank foreign exchange market has been progressively strengthening. Total transactions in 1999 amounted to 468 b. kr., an increase of 16% from the preceding year. The Central Bank's share in the market has decreased rapidly since 1996, when it was around 80%. Last year the Bank's share in transactions was 4%, and it has not traded in the interbank market since June last year. With continually decreasing Central Bank trading, market determination of the exchange rate is in effect on a more solid foundation than before. The foreign exchange index provides the Central Bank with better information about market conditions at any given time and thereby also about whether and when special action needs to be taken, either through interbank market operations or changes in the policy rate. It should also be borne in mind that one motive for Central Bank intervention can be to strengthen its currency reserves. Such actions need not by any means imply a change in foreign exchange policy, although it is natural under such circumstances for the Central Bank to inform market participants about these actions and their purpose. It is no secret that the Central Bank is interested in boosting its currency reserves when the opportunity arises.

Pension funds

Pension fund assets grew rapidly last year. According to provisional figures their net assets amounted to just over 515 b. kr. at the end of 1999 and had grown by 108 b. kr. in the course of the year, or 26.5%. Net pension fund assets at the end of 1999 were equivalent to 81% of GDP for the year.

The composition of pension fund assets continued to shift, and their foreign assets increased sharply. Foreign securities amounted to 96 b. kr. at year-end, accounting for just under 19% of total assets. Pension funds are clearly transferring an increasing part of their assets to foreign markets, but are still well within the ceilings imposed by law.

Pension fund holdings in domestic marketable securities and mutual funds increased by almost as much in 1999 as in the preceding year. Their holdings of treasury bonds decreased for another year, while their housing bond portfolio grew by more than 8 b. kr., reversing the trend of the year before. At the end of 1999 the pension funds' holdings of domestic and foreign equities amounted to 85 b. kr., having grown by 36 b. kr. in the course of the year. Just under half of that stock is in foreign equities. Their holdings in mutual funds were 47 b. kr., which is 29 b. kr. more than the year before, and almost entirely in foreign funds. I shall let these figures suffice for my coverage of the pension funds' activities. They show their large and growing force as financial institutions.

Financial stability

As reported at the last annual meeting, the Central Bank has been giving growing priority to monitoring the stability of the financial system as a whole. Research continued in preparation for the study of financial stability which was published in the Bank's quarterly Monetary Bulletin this February. Central banks have increasingly begun to monitor factors that could undermine the credibility of the financial system. Sudden financial crises which have struck in many parts of the world in recent years have increasingly focused attention on these tasks. Central banks are examining the strength and efficiency of the

financial system, and the macroeconomic environment and risks posed by it, as well as security of payment systems and various related factors. The Central Bank's initial study of the Icelandic financial system reveals both strengths and weaknesses. The positive aspects are high economic growth and generally good industrial profitability, although the higher real rate of exchange is squeezing some sectors. The position of Icelandic financial institutions appears to be secure and defaults on lending have declined. Asset prices have risen sharply recently and there is no probability of a sudden general drop this year. Furthermore, collateral limits in Iceland are generally lower than in neighbouring countries, and the share of short-term foreign borrowing by Icelandic banks has fallen. The Central Bank has a contractual access to foreign credit if necessary. One result of these combined factors has been that three international credit rating agencies have given the Republic of Iceland a good credit rating, which benefits other Icelandic borrowers in foreign markets.

The main weaknesses of the Icelandic financial system presently lie in the large current account deficit, monetary and credit expansion, the low equity ratio of many credit institutions and to some extent the sensitive foreign short-term position, although this has improved. These weaknesses are a task for general economic management as I have already discussed, but also involve the management of individual institutions, e.g. with respect to lending developments, falling equity ratio and overuse of foreign short-term credit. Each institution needs to pay attention to these issues in its own operations. Even though a certain element of risk is present in the Icelandic financial system, the overall finding is that there is no immediate threat, but it is necessary to address the problems that have been pointed out.

Examples of financial crises have been seen in various countries and different parts of the world over the past ten years, even among Iceland's closest neighbours. We can also be certain that such financial crises will continue to strike. The point is that we should arrange things in such a way as to reduce the likelihood of this happening in Iceland. The

Governors of the Central Bank have decided to strengthen this aspect of its activities even further, and to this end recently appointed an employee at the Governors' office specifically to handle these tasks.

Payment intermediation

The Central Bank has been focusing on payment intermediation to an increasing extent, as I have explained here at its annual meetings for the past two years. A legislative reform in 1998 assigned the Central Bank the role of promoting smooth, efficient and secure payment intermediation within Iceland and externally. In undertaking this work, an effort has been made to cooperate as closely as possible with Icelandic credit institutions. Various reforms are pending, and I shall mention the main ones now.

Work has been under way on establishing an independent company to operate the netting system and EFTPOS system. One purpose of the company is to grant new participants the opportunity of the same access to the netting system and its settlements that the present owners of the Banks' Data Centre enjoy. A project management team is engaged in these preparations and is expected to complete its work shortly.

In cooperation with the commercial banks and savings banks, the Central Bank has been preparing to issue regulations on access by payment systems to current accounts with the Central Bank. Preparation of these rules is now at the final stage. The Bank has also been interested in establishing a large payments system which would be a real-time gross settlements system. This means that payments above a specified ceiling would be cleared immediately and finally through the current account with the Central Bank.

These are examples of several important payment intermediation tasks which have been under preparation. They all serve the purpose of ensuring security in payment intermediation, equal access for all financial companies to the basic components of the system, and compliance with international standards.

Concluding remarks

Ladies and Gentlemen:

The global economic outlook has been improving recently. Iceland stands to benefit from this, given how dependent the country is upon international trade. The economic outlook in Iceland is also bright, but there is a pressing need for firmer management in certain fields which give cause for concern. Inflation and the current account deficit create the need for tight monetary and fiscal restraint. Clearly, monetary restraint can hardly be reduced. The Central Bank will continue to make an effort to contribute towards a decline in the inflation rate, and urges other parties involved to act towards the same end.

In the New Year, the Central Bank's position

within the government administration was changed and authority for it was transferred from the Minister of Commerce to the Prime Minister, as mentioned earlier. The Central Bank has enjoyed very pleasant cooperation with the staff of the Ministry of Commerce and with the Minister of Commerce, for which I duly express my thanks here. This cooperation will continue with respect to financial markets, although on a more limited scale than before. The Central Bank looks forward to good cooperation with the Prime Minister and the staff of his office. Extensive and good cooperation has already been established there, which is only natural given that authority for economic affairs lies with the Prime Minister. I would also like to thank other government authorities and financial institutions for their pleasant cooperation.