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## Low inflation is a cornerstone of growth and prosperity

*Address to the Annual Meeting, March 21, 2003<sup>1</sup>*

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 42nd annual meeting. The Bank's financial statements for the year 2002 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.

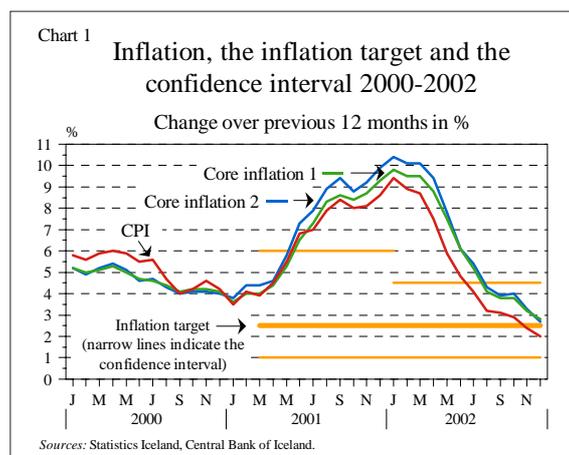
### *Inflation target*

The year 2002 was the first full year after new legislation on the Bank was passed and it moved onto an inflation target with a joint declaration by the Government and the Central Bank in 2001. The number of countries that have adopted an inflation target for their monetary policy implementation has increased sharply after New Zealand introduced such a policy in February 1990. In all, 21 countries have now moved onto a formal inflation target, including Canada, the UK, Norway, Sweden, Switzerland and Australia.

The chief characteristic of this arrangement is that price stability is the main objective of monetary policy. A declaration is also made stating that inflation will be kept within certain limits over a specific

period. The central bank is granted independence to attain this target with the instruments at its disposal. Other aspects of the new framework include increased transparency in monetary policy and communication of information from the central bank to the public and government. In most countries this has greatly stimulated discussion of monetary policy and central bank measures, on which opinion is divided as ever. Inflation forecasts play a vital role in monetary policy implementation under such a system. The expected inflation trend according to the forecast forms the basis for monetary policy decisions.

One consequence of this policy is that exchange rate stability is no longer the anchor of monetary policy. This is not because the exchange rate of any cur-



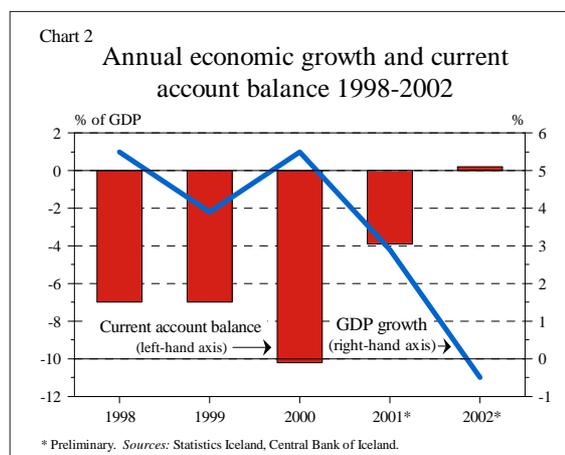
1. Translated from Icelandic.

rency is a lightweight factor in economic developments; rather, experience has shown that under free international capital flows, central bank instruments are inadequate for maintaining a stable exchange rate. Under conditions of free international capital flows, a central bank's primary instrument is interest rates, which in the long run can only attain a single macroeconomic goal, i.e. ensuring price stability. It has turned out that other countries have benefited from adopting such a framework.

It was in light of this international experience that the Central Bank of Iceland's monetary policy framework was changed two years ago and formal inflation targeting was adopted. Accordingly, the Central Bank is obliged to aim towards an annual rate of inflation which, measured in terms of the increase in the Consumer Price Index over a twelve-month period, should generally be as close as possible to 2½%. Inflation targeting was introduced in a climate where the economy was severely overheating. For this reason an adjustment period was set for the Central Bank, whereby it should aim to attain the inflation target by no later than the end of 2003. We have reason to celebrate the fact that inflation had already reached the set target by November 2002.

#### *GDP growth*

In 1996 a period of robust economic growth began in Iceland which did not come to an end until 2002. GDP growth in 2001 is estimated at 2.9%, which is more than in most industrialised countries that year. This growth phase ended with severe overheating of the economy. Among the forms this took was a current account deficit in excess of 10% of GDP in 2000 and twelve-month inflation which peaked in the beginning of 2002 at 9.4%. In 2002, a sharp turnaround took place in the Icelandic economy, under the strong influence of the Central Bank's tight monetary stance. A small surplus was shown on the trade account and better external balance put the exchange rate of the króna on a surer footing. The króna appreciated substantially during the year after sharp depreciation in 2001, when it most likely dropped considerably below the equilibrium exchange rate. Last year's rapid disinflation was not least the result of the substantial appreciation of the króna, which in turn can be attributed to better external balance, lower



inflation expectations as the year wore on, greater confidence in stability, and expectations that large-scale investment projects would go ahead. Disinflation last year can also be attributed to a considerable weakness in domestic demand. National expenditure contracted by 2½%. The decline in fixed capital formation was particularly pronounced, but private consumption also contracted. In spite of the contraction in national expenditure, however, GDP declined by only ½%. This was due to favourable foreign trade developments, with a contraction in imports and expanding exports.

The sudden turnaround in Iceland's current account from 2000 to 2002 is almost unparalleled among the developed countries. In 2002 there was a 1.8 b.kr. surplus on the current account, or 0.2% of estimated GDP. In 2000 the deficit amounted to more than 10% of GDP, as I mentioned earlier. This shows the great adaptability of the Icelandic economy, which to a large extent can be attributed to the wide range of reforms that have been made to the structure of economy in recent years, including changes in the monetary framework.

#### *Price developments*

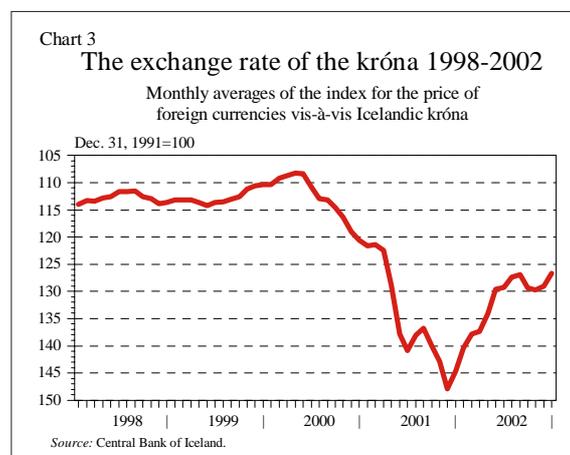
Now I shall turn to last year's inflation developments in more detail. In 2001 inflation climbed rapidly, from 5.6% at the beginning of the year to a peak of 9.4% in January 2002. Last year, inflation slowed down steadily and dropped to 1.4% in January 2003. According to the last two measurements, inflation has edged up again, to 2.2% at the beginning of March. This did not come as a surprise.

According to the joint declaration by the Government and the Central Bank of Iceland from March 27, 2001 on an inflation target and a change in the exchange rate policy, the Central Bank, in consultation with Statistics Iceland, was supposed to devise one or more indices for assessing the underlying rate of inflation, which the Bank could take note of in the implementation of monetary policy. Two such core indices have been published since November. Both are compiled on the same basis as the CPI, but Core Index I excludes prices of vegetables, fruit, agricultural products and petrol, and Core Index II excludes prices of public services as well. The components excluded from the two core indices are either fairly volatile or more or less beyond the impact of monetary policy, or they reflect relative price changes that monetary policy should normally not respond to. Over the past 12 months, Core Index I has risen by 2.6%, i.e. marginally more than the inflation target, and Core Index II by 2.3%. I would like to underline that, notwithstanding the publication of core indices, the CPI is still the official reference on which the inflation target is based.

For decades, a far too high rate of inflation was one of Iceland's main economic problems. This had an adverse effect on businesses, making effective planning difficult. It also had an adverse effect on households, partly because a large proportion of household debt is indexed to inflation. It is certainly a welcome achievement for the Icelandic economy to have triumphed over inflation. However, I cannot avoid mentioning here that I think many people take inflation rather too lightly and feel that too much emphasis is given to constraining it. I would caution against this view. I am certain that the same principles apply to Iceland as other industrialised countries, to which we tend to compare ourselves, namely that a low rate of inflation is one of the cornerstones of economic growth and public welfare and the Central Bank should therefore continue to have price stability as its main goal, as stipulated in current legislation. In addition, the other factors, such as fiscal policy and wage decisions, have a considerable impact on how tight the monetary stance needs to be.

#### *Currency floated*

The new monetary framework implied that a policy of a stable exchange rate was abandoned, allowing



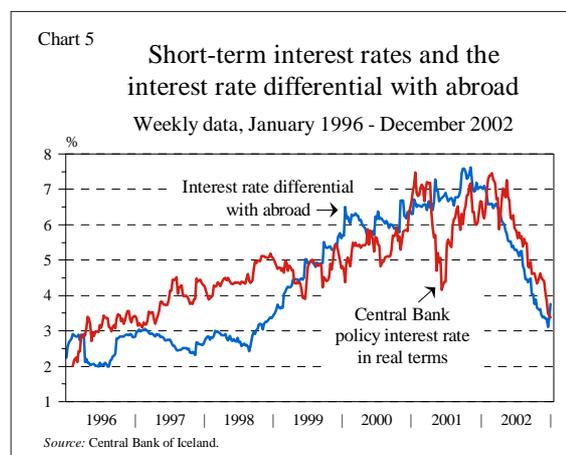
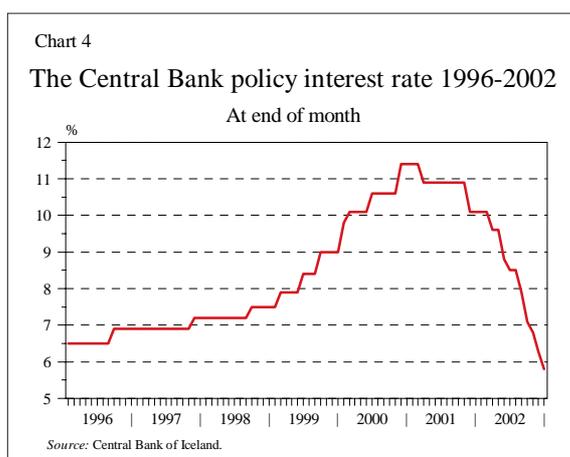
the external value of the króna to be determined by market forces. No one doubts for a moment that the exchange rate of the króna is crucial for the economy. The exchange rate has a major effect on prices and profitability in the traded goods sector. Recently there has been a great deal of discussion about the exchange rate and the Central Bank has frequently come under fire. A widespread misunderstanding seems to prevail that the Central Bank can control the exchange rate. People must realise that the Central Bank exerts a limited long-term impact on the exchange rate. The exchange rate depends on various economic factors, including foreign trade, foreign investment in Iceland and investment by Icelanders abroad, and last but not least expectations about future economic developments. For example, there is little doubt that expectations in connection with power-intensive industry have already influenced the exchange rate of the króna, which at present is stronger than if decisions on large-scale investment in aluminium production had not been announced.

Interest rates certainly affect the exchange rate, but experience in Iceland and elsewhere shows that in the long run this impact tends to fade out if monetary policy aims for rate of inflation close to the prevailing rate among trading partner countries. Likewise, the Central Bank's foreign exchange market intervention tends to have only a short-lived effect. If the exchange rate is moving with a strong momentum in a certain direction, no central bank can resist this for long. This is a common experience of all countries that have liberalised international capital movements, which was also shared by the Central

Bank of Iceland when it tried to stem the depreciation of the króna from mid 2000 until autumn 2001. Recent calls for the Central Bank to set an exchange rate target are unrealistic. The only way to fix the exchange rate while still retaining an independent currency is to return to the old regime and introduce currency controls, but who would want to return to such an arrangement? Exchange rate volatility is best prevented with economic policies which promote economic stability, but this does not only depend on the Central Bank. It is essential to take a long-term perspective. However, it should be noted that since September last year the Central Bank has been regularly purchasing currency in the foreign exchange market in order to boost its external reserve. The Bank's purchases of currency have amounted to more than 13 b.kr. since that time, and have undoubtedly weighed somewhat against the appreciation of the króna in the short run, although the long-term effect is negligible, if any at all.

#### Central Bank policy interest rate

The Central Bank's main monetary instrument is the interest rate on its repo agreements with credit institutions. In response to anticipated overheating of the economy the Central Bank began to raise its interest rates as early as 1997 and raised them rapidly in 1999 and 2000. In the beginning of 2001 the policy rate was up to 11.4%. Since then the Central Bank has lowered its policy rate 13 times and it now stands at 5.3%. Admittedly this is a higher level than among neighbouring countries such as the euro area, which



have to tackle the problems of persistent economic weakness and high unemployment. The outlook is also bleak, for example in Germany, judging from reports in the last few days. The European Central Bank has reviewed its growth forecast for the euro area as a whole and now expects 1% GDP growth. According to this, growth will be zero in Germany, because it will be higher in various peripheral regions of Europe. Thus the economic policy tasks that need to be tackled in Iceland and the euro area have been different, and still are at the moment. On the other hand, central bank interest rates in Norway are 5.5%, to cite a close industrialised neighbour. The Central Bank's policy rate is now 2¾% in real terms, which is somewhat below the current assessment of the equilibrium interest rate. The Central Bank's interest rates therefore act as a stimulus on the economy, being at their lowest level in real terms since spring 1996. It should also be borne in mind that interest rate changes affect demand and inflation with a considerable lag. Thus the impact of the extensive interest rate cuts in recent months is still being felt.

The credit institutions' required reserves with the Central Bank have been another of its monetary instruments, although the importance of this has diminished over the years. In recent years the Bank has been aiming to create operating conditions for credit institutions comparable to those in most other European countries, insofar as conditions permit. To this end, the Central Bank has been amending its rules in the past few years. The Board of Governors recently decided to change the rules on required

reserves, the first phase of which will enter into force today. The required reserve ratio will be lowered, thereby releasing liquidity for the banking system amounting to 8 b.kr., which ought to enable a reduction in interest rates in the banking system. Further changes are planned later in the year.

#### *Payment and settlement systems*

By law, the Central Bank shall promote an efficient and safe financial system, including payment systems domestically and with foreign countries. Payment systems and securities settlement systems are important components of the financial system, which makes it vital to ensure that they are active and reliable. This may sound like a fairly modest task, but it can be compared to a building that obviously serves its purpose well – we rarely ponder the piping and wiring that are hidden from our sight yet are vital to ensure that the building functions properly. The same can be said of payment systems and settlement systems. The financial system would definitely not be tenable if secure systems for payment intermediation and settlements were not in place.

The Central Bank has formulated a policy on these issues with the aim of adjusting Iceland's systems to international standards. In doing so it has taken particular account of an assessment made by the International Monetary Fund in 2000, on the extent to which Iceland's payment systems observe the so-called Core Principles. In the IMF's view, Iceland fulfilled only three of the ten Principles at that time. In particular it pinpointed the need to inform participants about systemic risk and establish risk management and settlement guarantees in the systems, set clear rules on their activities, draw up a contingency plan and increase system transparency. A great deal of work needed to be done and the Central Bank, in collaboration with financial institutions, has firmly underlined that Iceland's systems should be brought up to international standards.

#### *Netting and RTGS systems*

Initially it was decided that the main emphasis would be on developing a netting system for payments below the limits set for the real-time gross settlement system. It was also decided that once work on that system was well under way, further development of the real-time gross settlement system would be

addressed. Another necessary issue to consider was the securities settlement system, following the payment system reforms.

Operation of the netting system is in the hands of Fjölgreiðslumiðlun hf., which is jointly owned by the commercial banks, payment card companies and the Central Bank. The system handles netting of accumulated payment orders lower than 25 m.kr. Work has been in progress on a thorough upgrading of the system and has now largely been completed. Towards the end of 2002 a plan was drawn up for the collateral security amounts in the system and participants made these available to the Central Bank on January 1 this year.

Operation of the Central Bank's RTGS system started in 2000. It handles final settlement of individual payment orders of 25 m.kr. or above as soon as the deposit in the payer's account allows this to be done. The system thereby transfers payment orders, which are above the minimum needed to qualify for the RTGS system, directly to or from participants' current accounts with the Central Bank.

The RTGS system has a triple function. Firstly, the Central Bank uses the system for the implementation of its monetary policy; secondly, it is used in transactions by credit institutions with the Central Bank; and thirdly, it is used for gross settlements between credit institutions. The security and functionality of this system are thereby preconditions for enabling the Central Bank to achieve its objectives for both price and financial stability. Consequently, operation of the RTGS system has been assigned to the Central Bank, a familiar arrangement from many other countries. The Bank's duty is to strengthen the security, efficiency and independence of the system. At the end of 2002 agreements were made with all system participants specifying payment authorisations and collateral security for settlements. This represented a major step towards bringing arrangements for the credit institutions' transactions with the Central Bank into harmony with best international practices. Automatic Central Bank guarantees for settlements in the RTGS system are thus a thing of the past. Work is still in progress on developing the system. This year it is expected that the rules governing it will be revised, its independence be enhanced, collateral security amounts for settlements be reviewed, handling times be shortened and settlement limits be lowered.

### *Securities settlement system*

In 2002, the Central Bank put forward proposals for the development of the securities settlement system which is operated on the basis of an agreement between the Central Bank, Central Securities Depository and Iceland Stock Exchange. Proposals included clarification of rules for the system's operations, introduction of risk management, and expediting of payment orders from the Depository to the Central Bank and netting of them, so that credit institutions can be notified of their securities trading positions in order to prepare settlements which are made the following morning.

Following amendments made to the Public Limited Companies Act in 2002, requests were made for securities settlements to be allowed in foreign currencies. The Central Bank has participated in examining the possibilities of developing a settlement system for securities in foreign currencies, in collaboration with the Central Securities Depository, Iceland Stock Exchange and the commercial banks. Such a system would clearly pose new settlement risks. It would presumably be an option in this respect to establish a system which would be entirely operated by Icelandic commercial banks.

In all the work described here, the Central Bank has had a very good collaboration with financial institutions and other parties involved, and I would like to express my thanks for the close cooperation and good understanding that has been achieved among all the parties to this work.

### *Major industrial investments pending*

A number of important changes have occurred since the Central Bank published its last macroeconomic forecast in February. It has been decided to bring forward a number public sector construction projects and launch the expansion of the Norðurál aluminium smelter at Grundartangi. Furthermore, activity on the Kárahnjúkar hydropower project will be more intensive than was previously assumed. Combined with the cut in the Central Bank's policy interest rate in February, these three factors will lead to more demand in 2003 and 2004 than was assumed in the national economic forecast, and all things being equal this will spur GDP growth.

Central and local government authorities have decided to bring forward construction projects

amounting to a total of 10 b.kr., of which roughly 5½ b.kr. will be made in 2003 and 4½ b.kr. in 2004.

Plans have been made for expanding the Norðurál aluminium smelter in two phases. Production capacity will be stepped up by 90 thousand tonnes per year in 2005 and by a further 60 thousand tonnes in 2008 and 2009. In connection with the expansion, projects will be undertaken at Norðlingaalda, Nesjavellir and Reykjanes to supply power for the smelter. Investment on account of the Norðurál expansion will total 2½ b.kr. in 2003 and 14 b.kr. in 2004.

According to the latest projections by Landsvirkjun (the National Power Company) for hydro-power development at Kárahnjúkar its expenditure on the project will be 5 b.kr. higher in 2003 than previously estimated, and just over half a billion kr. greater in 2004.

In all, this represents a total extra investment of 13 b.kr. during the current year and 19 b.kr. next year, over and above the amounts assumed when the Central Bank's latest macroeconomic forecast was published last month.

On the basis of these new assumptions, preliminary studies suggest that economic growth could easily end up in the range 2-2½% this year and well over 3% next year. The annual growth rate is as much as 1% above what was previously forecast. The employment outlook has also improved considerably. Given that the negative output gap was never very wide, and that seasonally adjusted unemployment measured 3.2% in February and has changed little since September, it is clear that inflationary pressures are likely to develop much sooner than was previously thought. Inflation this year is likely to be close to the Central Bank's 2½% target, but other things being equal it could rise next year.

While it is foreseeable that these major construction projects could coincide to some extent in 2004 and 2005, most of the weight will be felt in 2005 and 2006. Thus economic policy implementation will face a greater challenge than was thought when only the Reyðarfjörður aluminium smelter and related hydropower development were foreseen. The new outlook calls for economic policy responses on both the monetary and fiscal side. While the scale of the response will be determined by exchange rate developments, it is clear that preventing overheating and

inflation will be a major challenge in the period ahead. Effective fiscal measures are necessary in order to prevent monetary policy from bearing the brunt of these pressures, since this would have an excessive impact on the traded goods sector. The firmer the fiscal stance is at the peak of construction activity, the smaller is the increase in the real exchange rate that will inevitably accompany it, with a correspondingly beneficial effect on current export and most competing industries.

#### *Ladies and Gentlemen*

The global economy is shrouded in uncertainty. A low rate of growth has been attained in most industrialised countries since 2001 and the recovery is slower than had been hoped. The war in Iraq heightens this uncertainty. Favourable economic conditions among main trading partner countries is important

for Iceland's terms of trade. A special cause for concern is therefore the deteriorating outlook in the euro area, which is important for Iceland's foreign trade.

The situation in Iceland is quite different. A prolonged growth phase was followed by one year, 2002, of a minor contraction, but at present we foresee a new period of growth when our task will be to maintain economic balance. Expectations of greater prosperity are already clearly visible.

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.