Birgir Ísl Gunnarsson: The policy and objectives of the Central Bank of Iceland

Article by Mr Birgir Ísl Gunnarsson, Chairman of the Board of Governors of the Central Bank of Iceland, published in the Morgunbladid Newspaper, in Reykjavík, 28 February 2003.

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When the Central Bank of Iceland became an independent institution in 1961 it was generally believed, both here in Iceland and abroad, that several different simultaneous objectives could be set for central banks. Low inflation, full employment and strong economic growth were among the objectives that people felt central banks should be able to achieve. Gradually it became clear that this would not work. In the work of a central bank, these objectives can come into conflict with one another, resulting in an economic fiasco.

As a result, in recent years legislation on central banks has been altered in many countries and the banks assigned one principal objective: ensuring price stability. Inflation is primarily a monetary phenomenon, persistent inflation being the result of insufficient restraint in monetary policy. In the long term, monetary policy thus has an impact on price levels but less on economic growth and employment. With free movement of capital between countries, the principal instrument of a Central Bank is interest rates; in the long run this instrument can only achieve one macroeconomic objective, i.e. to ensure price stability.

New legislation

When new legislation was adopted for the Central Bank of Iceland in 2001, these international developments were taken into consideration and the Icelandic Act patterned on recent legislation in other industrialised countries. There was broad political consensus on this, as people realised that low inflation is one of the cornerstones of economic growth and improved living conditions. In addition to the legislation, inflation targeting was introduced as the Bank's objective in a joint declaration by the government and the Central Bank. The decision to float the Icelandic króna was taken at the same time, since experience had shown that in the long run it was impossible to ensure a specific exchange rate with free movement of capital in and out of the country. In such case the exchange rate is determined by the market where supply and demand control the value of the króna.

This new framework for monetary policy was immediately subjected to a baptism of fire. The Icelandic economy was overheated and inflation rising rapidly. The Central Bank had to respond by raising interest rates. The fall of the króna played a part in the elimination of the current account deficit much more rapidly than anyone had dared to hope two years ago. The economy is more stable at the moment than it has been for some time and, acccording to the outlook, the current slight slowdown will be short-lived. The Central Bank's tight monetary stance has, on the other hand, brought results, as last November inflation dropped below the target of 2½ %.

Old theories reappear

Recently there has been extensive discussion concerning the Central Bank of Iceland, its policy and objectives. Now that inflation has been subdued, old theories to the effect that the Central Bank should pursue multiple objectives have once more come to the fore. The Bank is to ensure full employment, it should have specific exchange rate objectives and ensure economic growth. These views reflect considerable over-estimation of the power of the Central Bank and the instruments at its disposal. It is also an oversimplification to focus exclusively on interest rates, as many people do, and expect that further interest rate reduction will solve all the problems.

The Central Bank has, over the past two years, cut its rates thirteen times, and the bank's policy rate is currently 5.3%. While this is naturally a higher rate than in the Euro zone, the problems which have to be grappled with there include long-term economic stagnation and high unemployment, and the future is by no means bright. In Norway, on the other hand, the Central Bank rate is 6%, to take an example of a neighbouring industrialised country. The Central Bank of Iceland's real policy rate is currently around 2¾% considering future prospects, which is slightly under current estimates of the equilibrium interest rate. The Bank's interest thus has a stimulating effect on the economy, and note that real interest rates at present are lower than they have been since the spring of 1996. It should also be borne in mind that changes in interest rates only affect demand and inflation with a considerable time lag, so that the full effect of interest rate cuts in recent months will not be felt for some time yet.

ISK exchange rate

No one doubts the importance of the ISK exchange rate for the Icelandic economy. The exchange rate has enormous impact on price levels and the performance of the export and competitive sectors. On the other hand, people must realise that the Central Bank has only limited long-term effect on the exchange rate. Many aspects of the economy affect the exchange rate. These include, for instance, foreign trade, foreign investments in Iceland and investment by Icelanders abroad, not to forget expectations of future economic developments. There is little doubt that expectations concerning power-intensive industry developments have influenced the exchange rate in recent months. Interest rates certainly affect the exchange rate, but experience both in Iceland and elsewhere shows that this effect eventually disappears, as long as monetary policy aims at maintaining long-term inflation comparable to that of the country's trading partners. At the same time, intervention by central banks can have a temporary impact. If, however, the exchange rate is forcefully headed in a certain direction, no central bank can withstand this trend for any length of time. This has been the experience throughout the world, wherever there is free movement of capital between countries. This was also the experience of the Central Bank of Iceland when it attempted to check the slide of the króna from mid-year 2000 to autumn 2001. To demand now that the Central Bank adopt exchange rate objectives is unrealistic. The only option to peg the currency is to return to former practices and introduce currency restrictions, but who wants to go back to that? Cutting interest rates beyond what the Bank's inflation targets allow, in order to force down the exchange rate, would be highly inadvisable. The nominal exchange rate might temporarily drop somewhat, but it is practically certain that inflation would once more heat up and soon we would end up with the same real exchange rate as before, in addition to having kindled the flames of the next period of overheating and instability.

Slowdown in the economy

After a protracted period of high economic growth, which ended in overheating, we now have a slight slowdown in the economy and increased unemployment. It has, among other things, been claimed that this slowdown is in particular the result of a tight monetary policy. Our experience, as well as that of other countries, shows that a temporary slowdown is often an unavoidable consequence of strict economic management, aimed at controlling over-expansion and holding inflation in check. This is one reason why it is so important to prevent such waves from becoming too high. It is, however, an oversimplification to claim that monetary policy alone makes the decisive difference. Interest rates primarily affect demand in the economy. There are, on the other hand, many other factors which affect both demand and supply in the economy. These include, for instance, fishing quotas, public finances and public investment, foreign investment, e.g. in heavy industry, and the wage policy of the social partners. People who make these decisions control important economic instruments which are beyond the reach of the Central Bank. There are thus many parties involved in managing economic affairs and the Central Bank is far from the only party responsible here.

Actions to boost economic growth and reduce unemployment

Recently a number of actions have been announced to relax restraint in the economy. The full effect of major interest rate cuts in recent months has yet to be felt. The Central Bank has also announced imminent relaxation of reserve requirements, which will release funds in the banking system and should lead to interest rate decreases there. Each day the Central Bank has puchased foreign currency, in so doing placing some ISK 11 billion in circulation since September, which has certainly slowed the exchange rate rise. The government has decided to accelerate certain projects on which it will spend ISK 6 billion. Local authorities and other parties have announced measures aimed at the same objective. So it is clear that much has been done which can be expected to increase economic growth and reduce unemployment in the coming months.

Ahead of us are the most extensive construction projects in Icelandic history, which will have a major impact on the economy in both the short and long term. They will require sound economic management. It is important to foresee early enough what effects this development could have if no action were taken. It would be completely irresponsible to simply allow things to take their course as if nothing needed to be done to compensate for these developments, as has actually been proposed in some quarters recently. The Central Bank's analysis of the proposed development indicates that, with appropriate economic management actions, it should be possible to maintain economic stability and keep inflation under control. The Central Bank of Iceland will do its utmost to achieve this, as it naturally bears an indisputable legal responsibility to do so.