Birgir Ísleifur Gunnarsson: Current trends and prospects of the Icelandic economy in a global setting

Address by Mr Birgir Ísleifur Gunnarsson, Chairman of the Board of Governors of the Central Bank of Iceland, at the “Wirtschaftstag Island”, Berlin, 30 April 2003

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Mr. Chairman, Ladies and Gentlemen.

It has been said that Iceland is an extreme case of a small open economy. It has a population of just under 300,000, a GDP of around 10 billion USD and a stock market capitalization that is roughly one-tenth the market value of a moderate sized U.S. company. The small size, along with fluctuations in fish stocks and the terms of trade, make Iceland in many ways more vulnerable to external changes than larger countries. But by exploiting its abundant natural resources and a highly educated labour force, Iceland has been able to utilise its comparative advantage in the international division of labour, making its GDP per capita among the very highest in the world.

Over the past two decades, significant structural reforms have taken place in the Icelandic economy and financial markets. The objective of these reforms has been to achieve a market-based framework open to external influences. This process was accelerated by the need to better align the Icelandic economy with those of its European partners when Iceland became one of the founding members of the European Economic Area (EEA) in 1994 and thereby integrated into the internal market of the EU.

As a member of the European Economic Area Iceland is obliged to transpose into national law all existing and future EU legislation in the field of financial services. This has implied important changes in the financial system in Iceland. The EEA negotiations themselves intensified a trend towards liberalisation that started with the deregulation of interest rates in the mid 1980s and culminated in the liberalisation of the bulk of cross-border capital flows by 1995.

Important rationalisation has also taken place in the Icelandic financial system. Until 1999, two of the main commercial banks were fully government owned and so were a host of so-called investment credit funds. The funds were unified in a single privatised institution which subsequently merged with Íslandsbanki in 2000 to become the then largest commercial bank. The withdrawal of the government from ownership of financial institutions was finalised in March 2003 when the government sold its last shares in the commercial banks. Already by mid April a decision had been taken to merge one of the two former government owned banks, Búnaðarbanki, with Kaupþing Bank ltd. The new bank will be the largest commercial bank in Iceland and one of the 10 largest in the Nordic countries. The privatisation of the credit institutions has thus already created ample opportunities for rationalisation and will continue to do so in the period ahead. The reform of the financial legislation and its framework in line with that in other European states has facilitated the export of financial services by Icelandic financial institutions and the establishment of operations abroad. You will hear more about this process from the next speaker, Director Sigurdur Einarsson.

Foreign direct investment regulations are now liberal with the most important exception that such investment is not permitted in the fishing sector. Foreign direct investment is most noticeable in power intensive industries, such as the production of aluminium, which is based on Iceland’s abundance of renewable energy resources. Recent changes in corporate taxation in Iceland, lowering them to among the lowest to be found, serve to attract foreign business to Iceland and encourage Icelandic companies with international operations to favour Iceland as the base of their operations. Director Garðar Ingvarsson will probably give you more detail on this later this afternoon.

Direct investment by Icelandic companies abroad has risen rapidly in recent years and in a variety of areas, such as fisheries and fish processing, pharmaceuticals, retail commerce and as mentioned earlier, financial services. These developments also benefit the Icelandic economy in the long run as they integrate Iceland further into the global economy, allow Iceland to draw more easily on the experience of others and bring in dividends.

During the 20th century, Iceland tried almost every type of exchange rate policy, from a monetary union with Denmark to a managed float. There were long periods when the Icelandic króna was pegged against or managed with respect to the currency of some trading partner countries or a basket of currencies, with varying degree of adjustability and commitment. During the 1980´s the exchange rate regime had been relatively flexible. But in the first half of the 1990´s it became much more stable, after the króna was fixed in December 1989. Exchange rate stability during this period was one of the cornerstones of the successful disinflation policy that took inflation in Iceland down from double digits in the late 1980s to below 2 per cent around the middle of the 1990s.

Once the liberalisation of financial markets was more or less completed in the mid 1990´s, exchange rate flexibility was gradually increased. The margins around the exchange rate target were widened from 2¼ per cent in either direction to 6 per cent in September 1995 in order to allow for the possibility of greater fluctuations in the exchange rate with more volatile capital movements. In February 2000 the target band was widened further to 9 per cent in either direction in order to create greater scope for monetary policy which was increasingly focusing on the maintenance of price stability.

Recent experience around the world has demonstrated that it is difficult to maintain soft exchange rate pegs with free capital movements, and the same has been the case in Iceland. Furthermore, developments in the domestic economy at the end of last decade were such that the stable exchange rate policy was gradually undermined. During the second half of the 1990´s, the Icelandic economy entered a period of high economic growth. Growth was initially well balanced and led by exports and increased investment in the private sector. But as it unfolded it became increasingly driven by consumption and investment in the non-traded goods sector, fuelled by a foreign financed credit expansion in the wake of intensified competition among lending institutions and a significant increase in credit availability. By 1998, signs of overheating were already increasingly visible in rising inflation and the ballooning current account deficit which climaxed in 2000 at 10 per cent of GDP.

The Central Bank responded to the imbalances in the economy by tightening monetary policy. Through the effects of the tighter monetary policy, the exchange rate of the króna gradually appreciated as can be seen from Chart 1. In the spring of the year 2000 expectations in the market shifted for a variety of reasons; but concerns about the current account deficit and lower expectations of future economic growth were the most important. Subsequently the króna began to depreciate and continued to do so more or less uninterrupted, but on the whole in an orderly fashion, over a period of a year and a half until the end of November 2001. By that time, it had fallen from its peak by about a third against other currencies.

As I mentioned before, experience has shown, that in the long run, it is very difficult to maintain soft exchange rate pegs with the free movement of capital across borders. Iceland shares this experience with many other countries during the post-liberalisation face. The response to this has been the observed tendency to adopt hard pegs in the form of monetary unions or currency boards or to go in the direction of floating. As so many other countries, Iceland adopted the second route.

This was done in March 2001 by a joint declaration by the government and the Central Bank. The principal objective as stated in the declaration, is to keep inflation as close as possible to 2½ per cent. Should inflation deviate from this target by more than 1½ percentage points in either direction, the Bank is to provide the government with a written public account explaining what caused this deviation, how the Bank intends to respond and how long it expects that it will take for inflation to return to within the targeted inflation limits. In the wake of this declaration, the Icelandic Parliament adopted a new legislation on the Central Bank, giving it one overriding goal, i.e. price stability, and full independence to use its instruments to achieve it.

The new framework was immediately subjected to a baptism of fire. Overheating in the economy and the fall of the króna had rekindled inflation. As can be seen from Chart 2, inflation climbed rapidly from below 2 per cent in 1997 and 1998 to a peak of 9.4 per cent in January 2002. At the same time the short and medium term growth prospects of the economy deteriorated. Facing conflicting demands, from the inflationary pressures stemming from a weakening currency on one hand and the outlook for a slowing economy on the other hand, the Central Bank opted to lower interest rates by ½ percentage point when the new monetary framework was announced. But that cut was made from a very high level as the policy rate had peaked at 11.4 per cent.

The Central Bank kept a tight monetary stance until the spring of 2002, when it was clear that inflation would decline. Within less than one year, inflation was reduced from nearly 10 per cent to the target of 2½ per cent, and even below it for a while. Furthermore, the current account deficit disappeared in a matter of two years, partly due to the depreciation of the króna. This turnaround was much more rapid than might have been expected and is almost unparalleled among the developed countries.

The economy is currently in a relatively good balance. But once you are in calm waters new challenges usually emerge. Ahead are new investments in the aluminium sector and related power plants, that will commence in 2003 and most likely continue until 2010. In economic terms these new investments will amount to over 30 per cent of one year's GDP and increase Iceland's annual production capacity of aluminium from 270 to 740 thousand tons.

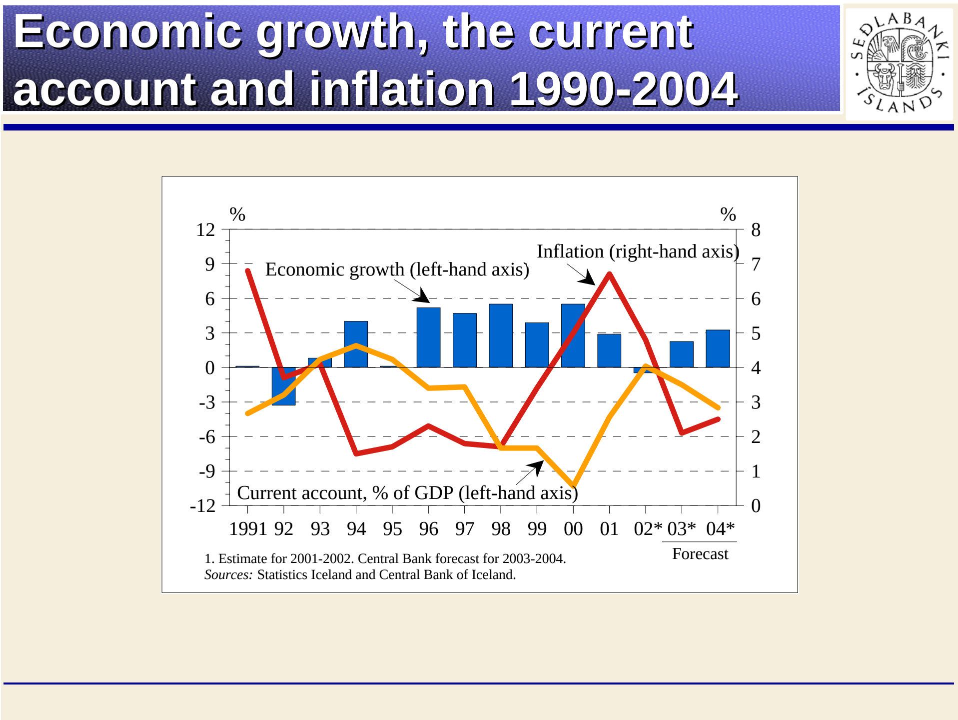
The economy appears to have already begun adapting to the coming projects as reflected in exchange rate movements. As can be seen in chart 2. the króna was quite stable from the spring of 2002 until late in the year. It then began to appreciate and continued to do so steadily until early February 2003. It seems that the recent rice of the exchange rate is primarily due to the effect of the proposed construction projects on expectations. The current assessment indicates that economic growth could easily end up in the range 2-2½ per cent this year and well over 3 per cent next year. The outlook is for inflation to remain close to the inflation target during 2003 but it could rise in 2004.

As these are the most extensive construction projects in Icelandic history, sound economic management will be required to prevent overheating in the economy, inflation and instability. Although their scope will be considerable, the Central Bank's analysis of the prospective development indicates that, given appropriate economic policy and some strengthening of the króna, significant part of which might already have taken place, economic stability could be maintained and inflation kept under control. While monetary policy will probably play the major role, fiscal policy will have to assist. Otherwise there is the danger that the burden of the adjustment will be born disproportionally by the traded goods sector that might have detrimental medium term consequences.

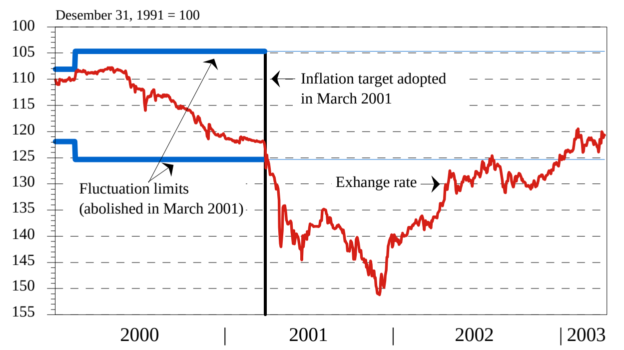
While the near term outlook in the global economy is rather gloomy, the situation in Iceland is quite different. A prolonged growth phase was followed by one year, 2002, of a minor contraction, but at present we foresee a new period of growth when our task will be to maintain economic balance. The Central Bank is determined to keep inflation under control during the coming years of extensive activity in the economy, thus maximising the long term benefits of the extension of the export base.

Ladies and Gentlemen

The structure and diversity of the Icelandic economy has changed radically in recent decades and the legal framework has been modernized. Only a few decades ago the Icelandic economy had a narrow production base when fishing and fish processing were by far the most important activity. Today, the Icelandic economy has a broad base. Fishing continues to be important, but various industries have also developed, exploiting among other things the vast opportunities offered by the revolution in information technology. Strong companies successfully compete in the international market in various fields, including among other things communications and financial services. The liberalization and opening up of the economy demand close cooperation with other nations. In that respect it will be important to cooperate with businesses and public authorities in Europe, not the least in Germany. I hope that the meeting here today makes an important contribution to that effort.



The nominal effective exchange rate of króna January, 2000 – April, 2003



Source: Central Bank of Iceland.