Birgir Ísleifur Gunnarsson: The Central Bank of Iceland and monetary policy

Address by Mr Birgir Ísleifur Gunnarsson, Governor of the Central Bank of Iceland, to a meeting of the Reykjavík Rotary Club, Reykjavík, 27 August 2003.

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I have been invited to discuss here the economic and monetary situation and prospects from the perspective of the Central Bank of Iceland. Before turning to that subject I believe I should devote some discussion to the monetary policy framework which has been in place since March 2001. My reason for doing so is the misunderstanding, which still often arises in public debate, about the Central Bank's role and its possibilities for influencing specific aspects of the economy. What I have to say on that point, it seems, cannot be stated too often.

Iceland's monetary framework was altered in March 2001 when the Government and the Central Bank issued a joint declaration adopting inflation targeting as the anchor of monetary policy.

The chief characteristic of this arrangement is that price stability is the main objective of monetary policy. It has also been declared 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. 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. In most countries this has greatly stimulated discussion of monetary policy; central banking and central bank policies and measures are more in the spotlight and public debate than before, although of course opinions about them are divided as ever.

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 currency is a lightweight factor in economic developments; rather, experience has shown that in a climate of unrestricted cross-border capital flows, central bank instruments are inadequate for maintaining a stable exchange rate. When cross-border capital flows are unrestricted, 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 whereby the Central Bank should aim to attain the inflation target by no later than the end of 2003. In fact, this target had already been reached in November 2002. 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 and hit a peak of 9.4% in January 2002. Last year, inflation slowed down steadily: it has been below the Central Bank's target since November and around 2% over the past four months. In the beginning of August 2003 the twelve-month rise in the CPI measured 2%. While the CPI is used as the official inflation rate reference, two other indices are published, core indices which provide a clearer picture of the underlying rate of inflation. The core indices exclude price components that are either fairly volatile or more or less beyond the impact of monetary policy, or that reflect relative price changes that monetary policy should normally not respond to. Core Index I excludes prices of vegetables, fruit, agricultural products and petrol, and Core Index II excludes prices of public services as well. Over the past 12 months, Core Index I has risen by 2.7% and Core Index II by 2.4%. Underlying inflation is therefore somewhat closer than the CPI to the Central Bank's target.

It is interesting to examine the development of individual components of the CPI. The housing component, for example, has risen by 13.6% over the past 12 months and the upward trend shows no sign of coming to an end. Public service prices have also had a considerable impact on the CPI over the past 12 months, but the rate of increase has slowed down. Measures taken to forestall an inflationtriggered national wage review in 2002 included a freeze on public service prices, which was relaxed when the risk connected with exceeding negotiated inflation ceilings had abated. There has also been a slowdown in the twelve-month rise in private services, which are highly sensitive to domestic wage increases.

On the whole, goods are more sensitive than many other index components to changes in the exchange rate. Last year's strengthening of the króna is clearly reflected in goods prices, with a significant drop in import prices. In 2003 prices of both imported and domestic goods have fluctuated somewhat.

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. I sometimes think people take inflation rather too lightly and some of them feel that too much effort is devoted to constraining it. This may be normal, since the business community is now dominated by generations who do not know inflation at first hand and perhaps therefore fail to realise the great problems that accompany it. I would caution against such views and feel that the same principles apply to Iceland as to other industrialised countries with 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, the Central Bank Act of 2001.

As I pointed out earlier, the new monetary framework involved abandoning the fixed exchange rate regime, and instead the króna was floated and determined by market forces. A foreign exchange market had been established in Iceland in 1993 and the Central Bank was supposed to maintain the exchange rate within a relatively narrow target band of 2¼% in either direction around the central value of the króna. With increasing exchange rate deregulation the target band was gradually widened and set at 9% in either direction in the beginning of 2000. No one doubts for a moment that the exchange rate of the króna is crucial for the economy, through its major effect on prices and profitability in the traded goods sector. There has been a great deal of discussion this year 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 has certainly firmed as a result of decisions on large-scale investment in aluminium production.

Interest rates definitely 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 a 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 cross-border 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. An interesting article on this topic by two Central Bank employees, Gerdur Ísberg and Thórarinn G. Pétursson, was published in the February 2003 edition of Monetary Bulletin, which traces the history of Central Bank interventions in the foreign exchange market over this period and evaluates their impact. The article concludes definitively that at best the intervention had only a short-term effect in each case and the market soon returned to its previous situation. In other words, their conclusion is that intervention on the foreign exchange market against strong prevailing currents has precious little effect. This is in full accord with the experience in other countries.

Calls for the Central Bank to set an exchange rate target are therefore 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 obviously no one wants 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. Market interventions in 2000 and 2001 depleted the Central Bank's foreign reserves, creating a pressing need to strengthen it. The

Central Bank has been engaged on this task and will continue to do so. It had purchased foreign currency for the equivalent of 30.7 b.kr. since September 2002, which has undoubtedly exerted some impact on the króna in the short run, although the long-term effect is negligible, if any at all.

The exchange rate for the króna plummeted in 2000 and 2001, and for quite some time was substantially below a level reconcilable with long-term equilibrium. This occurred at a time when the price of key exports was very high, making the years 2000 and 2001 especially favourable for the export sector and in fact also for import-competing sectors. Enterprises in these sectors understandably felt the effects of the rise in the exchange rate in the first half of this year. It is not to be expected, however, that the same conditions will re-arise in these sectors as prevailed, for example, during 2001 and in the early part of 2002. The exchange rate remained very stable from spring to early winter 2002, when the króna entered a strengthening phase which continued until the beginning of February. The Central Bank has stated its view that the appreciation over this period was primarily the effect of planned aluminium-related investments in East Iceland. Operation of a new aluminium smelter will also lead to a higher equilibrium exchange rate for the króna than would otherwise be the case. A sizeable currency inflow will obviously take place in connection with the aluminium projects and domestic interest rates will be higher than otherwise. All these factors have affected market expectations and caused the króna to strengthen. In effect, the economy has already begun this year to accommodate the pending investments. In recent weeks the exchange rate has depreciated once more. The króna had clearly overshot, as is common in foreign exchange markets. More factors have contributed to the weaker exchange rate. These include increasing uncertainty about hydropower development in connection with the Norðurál smelter extension, a deficit on the current account, and greater foreign portfolio investment by Icelanders which amounted to 14.5 b.kr. during the first six months of 2003 compared with 6.8 b.kr. over the same period the previous year. Central Bank currency purchases have had some effect, as I mentioned earlier. Such fluctuations are always to be expected and it should be reiterated that the Icelandic króna has by no means shown any more volatility than we see in other currencies.

Let us briefly consider what lies ahead. Four times a year the Central Bank produces macroeconomic and inflation forecasts which it publishes in its *Monetary Bulletin*. Inflation forecasting plays a vital role for Central Bank policy. Each inflation forecast is projected two years ahead, quarter by quarter. As in all countries, changes in the central bank interest rate are transmitted to the economy with a considerable lag. Monetary policy therefore needs to be forward-looking and the inflation forecast based on the best available methodologies. If the scenario is that inflation will head beyond the Bank's target, the Bank will raise its interest rates, while it will reduce them if inflation is tending below the target.

Let us first look at the macroeconomic forecast, which of course is a major consideration for future inflation. The main assumptions are that the Central Bank's policy interest rate, currently 5.3%, will remain unchanged for the forecast period, which is a standard forecasting assumption, and that the exchange rate will be 3% weaker than in the February forecast, with a reference value of 124. However the exchange rate index has continued to rise [i.e. the króna weakens] and currently stands at 128. Another assumption is that fiscal policy will not deliver a stronger demand impulse than has already been decided. In other words, the fiscal stance will be relatively neutral, apart from a considerable increase in public sector investment this year and a contraction next year. This implies that the Treasury balance will not be disrupted by discretionary measures on the expenditure and revenue side. Public consumption is expected to be below the historical average.

On the basis of current assumptions for the development of external conditions this year and in 2004, prices of marine products are now expected to fall by 4% this year and to remain unchanged between 2003 and 2004. Exports of marine products are expected to grow by 3% this year due to increased quotas for the fishing year [beginning September 1] and a larger blue whiting harvest this summer. The assumed increase in catch volume for 2004 is 5%. Aluminium prices are expected to rise by 4% this year, based on futures prices and the pricing assumptions of the two aluminium companies, Norðurál and Alcan Iceland.

Import prices in foreign currency are expected to decrease by ½%. Fuel prices are based on futures. These have been on an upward trend in recent weeks and are now expected to rise by 9% this year but fall by 14% in 2004. The terms of trade for goods and services are expected to deteriorate by 1½ percentage points this year. In 2004 they are expected to improve by three-quarters of a percentage point. Assumptions for short-term foreign interest rates are 3% this year and 3½% next year.

According to the Central Bank's macroeconomic forecast, output growth will be 2¾% this year and 3½% in 2004. This forecast assumes that the Norðurál aluminium smelter expansion will go ahead; if not, the respective growth figures would be 2¼% and 2¾%. Private consumption growth is forecast at 2% this year and 3% next year. A 2½% increase in public consumption is expected for both years. Gross fixed capital formation, however, is expected to grow by 10¾%, mainly as a result of investments connected with the aluminium industry. Forecast investment in residential housing is 3%. Exports will increase by 2% this year and 4% next year, according to the forecast, due to the increased fishing quotas that I mentioned earlier. Growth of imports is expected to be 4½% this year and 7% in 2004.

Despite higher forecast output growth this year, unemployment is expected to be a quarter of a percentage point higher than was forecast in May, at 3¼%. Estimated slack in the labour market this year has been revised upwards. However, unemployment is expected to head down to a figure of 2½% next year.

Although higher output growth is expected this year and next year, the output gap is forecast to become slightly negative. A revised estimate now shows a slightly negative output gap last year, which will widen even further in 2003 since output growth is below estimated growth of potential output. The output gap is expected to turn marginally positive next year, when output growth will exceed potential. However, it is important to bear in mind that the evaluation of the output gap is highly uncertain, due to the non-observable nature of potential output. These data do show, however, that good balance is expected in both 2003 and 2004.

The Central Bank forecasts inflation up to two years ahead. One year ahead, the forecast is for an inflation rate of 1.6%, which will accelerate gradually until it reaches the inflation target in the first quarter of 2005 and goes up to 2.8% two years ahead. Subsequently, inflation will continue to gain pace if the forecast assumptions hold, including an unchanged monetary stance. Such forecasts are inherently prone to uncertainties, which in the present forecast in the short run largely involve exchange rate developments, as always. In fact the exchange rate has weakened since the forecast was made. A delay in construction work for the Norðurál smelter expansion could reduce domestic demand and thereby dampen domestic inflationary pressures. Offsetting this, the króna could probably weaken, as we are seeing now with a partial reversal of expectations about currency inflows for these investments. The uncertainty about the global economic outlook and the pessimistic tone in the first half of this year appear to be abating, at least in the US, even though the prospects in Europe are not promising.

As I mentioned earlier, the policy interest rate is the Central Bank's main instrument for attaining its inflation target. The Central Bank last changed its policy rate on February 10 with a reduction of 0.5 percentage points to 5.3%. The Governors of the Central Bank of Iceland have not considered that there are grounds for altering interest rates now, given the analysis and inflation forecast that I have outlined here. Regarding deviations from the inflation target, it is important to bear in mind that a successful and credible monetary policy gives more weight to long-term than to short-term considerations, and that it is neither possible nor optimal to fine-tune the inflation rate with excessively volatile interest rates. We still consider the likely outlook that interest rates will remain unchanged for the time being, then rise as the peak of aluminium-related investments approaches. However, the point at which it may be necessary to raise interest rates could be further away than was previously foreseen, since inflation has been very low recently and will continue to be. As always, the outcome will depend on future developments. In light of the present low rate of inflation it cannot be ruled out that negative shocks to domestic demand and to imported inflation might call for a temporary reduction in interest rates from their present level. This could occur, for example, if proposed investments in connection with the Norðurál smelter expansion do not go ahead, if domestic demand driven from other sources than aluminium industry investments turns out much lower than is currently expected, or if deflationary pressures continue to build up in the global economy. Nonetheless, the weakening of the króna in recent weeks reduces the likelihood that interest rates will be lowered. Monetary policy will be reassessed when the occasion demands, and in particular when the fiscal and housing finance policies are made public.

Broadly speaking, economic and monetary developments and prospects provide growing signs of an ongoing recovery, mostly indicating that the upswing will gain momentum during the coming winter. Some slack still exists in the economy, however. There are no clear signs of a turnaround in the labour market and seasonally adjusted unemployment has still not decreased. Leading indicators such as credit growth, business surveys of labour demand, and growing turnover and imports nonetheless strongly suggest that demand will rise in the near future. Boosted by increased quotas during the coming fishing year, more public sector construction projects and aluminium industry investments, a reasonable level of output growth can be expected this year. However, since the growth rate is below estimated potential, the slack in the economy will increase slightly compared with 2002. The growth rate in 2004 is expected to exceed estimated potential at 3½%, meaning that the output gap could turn positive next year. Inflation will nonetheless remain below the Central Bank's target until the final quarter of 2004, according to the forecast. This is explained by the low current rate of inflation and excess output potential. Two years ahead, inflation is forecast to creep above the target. On the whole the future looks fairly bright, but as always we should not allow the celebrations to get out of hand.