

Davíð Oddsson: Recent economic and financial developments in Iceland

Speech by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a seminar organised by the Iceland Chamber of Commerce, Reykjavik, 7 November 2006.

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I would like to thank the Iceland Chamber of Commerce for giving me the opportunity to say a few words here as has become customary at this time of year, following the Central Bank of Iceland's interest rate decision and the publication of *Monetary Bulletin*. That publication provides indications of the position and outlook at the end of this year and what is to be expected over the forecast horizon of the next two years. Of course the Bank's long-term forecasts are presented with due humility and respect towards the uncertainties that time may bring. Something of a milestone was reached on November 2 when the Board of Governors of the Central Bank decided to leave the policy interest rate unchanged at least until the next interest rate decision day, which was in fact brought forward to December 21. The last decision marked an end to 17 successive hikes on interest rate decision days.

At this juncture it is uncertain whether a real turning point has been reached, because the decision was presented more as a deferral of a rise in the policy rate than as an end to the hike process. In other words, the data available to the Central Bank supported raising the policy rate still further. In itself, comparing the long-term forecasts with the inflation target would have justified raising the policy rate rather than leaving it unchanged. And subsequently some people have asked: Given the probability and arguments supporting such a decision, why wait? However, the Governors referred to the more benign short-term and long-term inflation outlook since the publication of the previous forecast [in July] and that in many important respects it seemed more positive than was considered likely then. Inflation developments were more favourable than expected. Wage rises and wage drift were also lower and housing market activity more subdued than had been projected. In addition, oil prices have been on the decrease and credit growth has slowed down. In view of these developments, although in many ways they involve only short-term changes in indicators that are known to be volatile, the Governors felt there was ample reason to wait, at least for the time being.

A large amount of information will of course reach the Board of Governors before December 21. If the pointers continue in this direction, there may conceivably be no need to increase further what is already undeniably a tight monetary stance. On the other hand, if nothing of particular note is reported, the analysis at hand when the current interest rate decision was made will determine the decision on December 21 and a policy rate hike could be in the offing. As far as can be seen, there is reasonable consensus on the Central Bank's decision among the main observers in Iceland and abroad. People may well question and in fact some already have the Bank's grounds for its concerns and its strongly worded message, bearing in mind the short-term and long-term downturn in inflation, slower credit growth, lower oil prices and substantially less wage drift than was feared. The answers are obvious from the Bank's core writings on these issues. They show that a tight monetary stance must be maintained for longer than would seem to be generally expected.

Inflation has certainly slowed down but it is still running high and will continue to do so, and for quite a while will remain incompatible with the target and main tasks assigned to the Bank. Almost everywhere we look, strong pressures persist in the economy. The labour market is greatly overstretched and labour demand is enormous. This has been met with heavy imports of labour and it is questionable whether such a swift influx is necessarily beneficial or healthy for Iceland in the long run, despite making the battle with inflation easier for the moment. In the banking sector, credit growth remains robust even though it is now slower than at the peak, and is still unsustainable in the long term. Now that the banks have fortunately managed to secure medium-term funding, the risk is that they will become more complacent and ease their restraint. Such signs seem to be emerging. The housing market appears to be picking up again and household and business sentiment is still very upbeat. Finally, Iceland's current account deficit relative to GDP is presently the widest in the world. And while it is forecast to shrink next year, the deficit will remain large and eventually have to be settled. Funding the accumulated deficit will leave the economy highly dependent on investors and creditors in the markets, with precious little scope for manoeuvre. Thus the Icelandic economy is exposed to potential shocks which may prove tough to tackle.

The Treasury is in a strong position and has achieved much in recent years. But according to a familiar pattern, the Treasury may be less willing than usual to proceed cautiously at this stage of the

electoral term, and it too is showing signs of easing which may drive demand and stoke the flames of inflation. Such criticism must of course be qualified by the Treasury's impressive record in paying down its debt in recent years to establish a completely new and favourable balance of interest flows from which Iceland will benefit for a very long time. Recently the Treasury's deposit in the Central Bank has amounted to around 100 b.kr., earning it handsome interest revenues. The Government has announced that it has agreed to Central Bank proposals for almost doubling the foreign reserves, which will be followed by talks on strengthening the Bank's capital position. There were no specific reasons for these measures, which are merely aimed to adjust the Central Bank's position to reflect Iceland's rapidly expanding economy and financial sector. The idea for building up the reserves was aired at the Central Bank's annual meeting in March this year, so it should not come as a surprise.

Given the scenario I have been describing, the Board of Governors seems to have ample justification for taking this pause to consider the position carefully and decide the next steps, not only with reference to the more positive assumptions that have now emerged since the July forecast, but also by examining the risks I have mentioned. If the current outlook holds and everyone stays alert and strong, inflation will be brought down over a relatively short period. The most important consideration is to achieve a satisfactory course for the exchange rate, whereby the current account deficit will primarily be reduced by increased exports, decreased imports of capital goods and a sufficiently tight stance to deter consumers from spending on other imports. The other and much less favourable way to adjust the current account would be through a sharp currency depreciation. Such action would have many uncomfortable side-effects which are well known. As yet, the former option is much more likely namely a soft landing.

A soft landing after one of the sharpest upswings ever would represent a success confirming beyond all doubt that the Icelandic economy is highly adaptable and can respond more quickly than larger and more cumbersome systems, and that the largest investment in the country's history followed by restructuring of the banking sector and housing market has not proved too much of a challenge for economic policy. It would be going to far to call such an outcome a miracle, but it would certainly be satisfying. Because over this same short period, enormous assets have been built up in Iceland. The infrastructure of the economy, and know-how within it and in the main business sectors have all strengthened, and Iceland's competitiveness and potential for expansion at home and abroad have improved enormously. The old cliché of Iceland's undiversified economy which also happened to be a fact is a thing of the past.