Davíð Oddsson: The ongoing battle against inflation

Opening address by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a breakfast meeting of the Iceland Chamber of Commerce, Reykjavík, 6 November 2007.

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Last Thursday's decision by the Board of Governors of the Central Bank of Iceland to raise the policy interest rate appears to have taken many people by surprise, though few seem to view that surprise as a welcome one. However, the Board of Governors considers that, over the past several months, it has issued a number of signals indicating the possibility of a policy rate hike. On the last two interest rate decision dates, in July and September of this year, the Bank emphasised strongly that the short-term inflation outlook had deteriorated and that, in the absence of a change for the better, it would respond in line with its duties. On the latter decision date, in September, it could be discerned that the Bank wished to wait yet awhile to see if the outlook would improve against all odds. It wanted to see the outcome of the turmoil in the global and domestic financial markets in August, and to see how the budgetary bill for next year would be received.

If the Central Bank had stayed its hand now, despite the worsening outlook and the myriad of indicators of continuing deterioration, accusations of indifference, and even cowardice, would have been appropriate in view of the criticism to which the Bank has been subjected recently, some of it from quite unlikely sources. A few decades ago, when Iceland was engaged in disputes over its territorial fishing waters, we shot blanks first before loading the weapons on our tiny Coast Guard cruisers with real ammunition, and even then we thought it sufficient to shoot wide of the mark rather than aiming directly at the alleged offenders. The Cod Wars are bathed in a romantic glow in Icelandic history, but they were no small matter at the time, a daring game of chance by a tiny country contending with much larger neighbours. At one point it was said that Icelanders had won that unequal battle, that we couldn't have afforded to lose it. The same applies, actually, to the fight against inflation. We can't afford to lose it. Inflation must not take root in this economy again. We must take decisive action against it, no matter how unpleasant – or even costly – the effort may be in the short run. There is no need to go into detail about the consequences of inflation for the income and financial position of businesses and households; the repercussions are familiar enough.

It is often said, even by supposedly responsible people, that the tools used by central banks all over the world to combat inflation will not work here in Iceland, not least because of the way globalisation treats small currencies like the króna, and because of how many investors, through the shelter afforded by globalisation, have the means to avoid the Central Bank's thumbscrews. The cannons on Iceland's coast guard cruisers were no weapons of mass destruction, and the difference in size between Thór and Aegir, on the one hand, and the British navy, on the other, was horrific, but we managed nonetheless. Of course, a reference to the Cod Wars is merely a metaphorical one, and I use it more or less in jest, as it doesn't fully apply to the current situation. But the comparison between the Central Bank of Iceland's tools and those of other central banks, which enjoy the relative security of a large currency, is worth examining. In the past few months, though, large currencies have not been protected from tremors, shocks, and even wide fluctuation. For example, the euro has appreciated by more than 70% from its weakest point against the US dollar, an enormous change in a relatively short period of time. The Icelandic króna has not been nearly so volatile despite all of the shocks it has had to tolerate. A volatile króna in a turbulent season tends to indicate that the króna is effective as a currency, and not the reverse. When interest rates and capital flow allow it, the króna appreciates, whether people like it or not. When there is a credibility loss in the market, either in Iceland or abroad, the króna will depreciate suddenly and sharply, and when there are tremors and rumblings in the economy, domestic or foreign, the exchange rate tends to resemble a Meteorological Office seismograph. In short, the króna functions just like any other currency, and if it did not react in this way to these conditions, we should complain loudly indeed.

Globalisation has made a massive impact on all markets and all currencies, and there is little doubt that, until now, it has lightened the load borne by central banks and central bankers in the battle against inflation. This could well change in the future, so that central banks will not have it as easy as they have recently. Peoples and nations that have hitherto been isolated from the principles governing most Western nations have been entering the world of international business in the past few decades. At first that entry was slow, careful, and even ponderous, but it has gained pace and become bolder year by year. The new entrants are China and India, either of which is larger in terms of population than the US and the EU combined. A huge number of diligent and eager employees, who still work for shockingly low wages, are streaming into the labour market and producing goods at a far lower price than would be possible in the West. The importation of these goods has counteracted inflationary pressure in Western nations and kept it within the bounds of manageability. But as a result, this newly awakened world gives rise to a growing number of hopeful consumers who lack all of the things we in the West have so long taken for granted, things we couldn't live without. They are consumers who, for the first time, have money in their hands.

These two groups overlap somewhat, of course, but it is clear that the former group has been instrumental in the battle against inflation in the West. It could well be, however, that the latter group will eventually put its weight on the other end of the scale. Globalisation has undeniably eased the battle against inflation, both in Iceland and elsewhere, so it is doubtless inaccurate to assert that globalisation is the reason we are having trouble conquering inflation. Other factors have been much more troublesome, and most of them are home-made. For example, we haven't managed to contain public investment during an economic upswing – this is eminently clear to anyone who examines figures on public investment, which increased by more than 20% last year and is still growing this year.

There has been an enormous increase in lending activity at a time when the nation is engaged in the largest investment it has ever undertaken, its financial system has been revolutionised, and the housing market has seen a virtually unparalleled injection of capital, to name just a few things. Neither can it be denied that competition has abated considerably, the market has become much more concentrated, and duopoly is common. It cannot be debated that effective competition in as many areas as possible is the main premise for the successful transmission of any central bank's decisions into the economy.

Managers of companies in the export sector have complained vociferously about the policy and activities of the Central Bank of Iceland. Their comments and criticisms are understandable, especially those coming from the fishing industry, which has had to stand up to the double blow of unfavourable exchange rates and an unavoidable cut in the cod quota. What has lightened the load for exporters, however, is that many of them, especially those in the aluminium and fishing sectors, can command high export prices at the moment. But while we must understand that exporters are dissatisfied with the current circumstances, it is not a given that their complaints are founded on the right premises. Many people consider the exchange rate of the króna disquietingly high and blame the Central Bank's interest rate policy for it. This is correct, of course, to a point: the Bank's policy influences exchange rate developments to a considerable degree, and the exchange rate is higher than Iceland can tolerate for the long term.

But the Central Bank's high policy rate is not the source of the problem. It is a response to the conditions reigning in our economy: strong excess demand no matter where one looks, large output growth, sharp increases in purchasing power, excess demand for labour, influx of capital … the list goes on. The Central Bank decided to raise the policy rate now because inflation has risen once again, and indicators suggest that it will be higher in 2007 and 2008 than earlier projected. Demand has grown more rapidly than was expected when the Bank announced its last interest rate decision. Output growth is greater than estimates allowed for. Private consumption is on the upswing, and indicators imply that consumption growth will accelerate even further. Gross capital formation was greater in 2006 and 2007 than previously estimated. Real estate prices continue to rise rapidly, pushing inflation upwards as well. A shortage of labour, wage drift, growing wage costs, and rapidly rising disposable income are also contributing factors. And it appears as though some people think that, under these circumstances, the best solution is to let an inflation episode flow through the economy, as it were. But inflation wouldn't merely flow through; it would pass into the economy and settle there. It would fester and be harder to uproot as a result. Such a suggestion is preposterous, and we can simply forget it.

The exchange rate of the króna is high in an historical context, to be sure, and a depreciation is factored into the Central Bank's forecasts. The Bank has emphasised strongly how important it is that the economy begin to cool off before the exchange rate drops too much, so that the depreciation will have less of an effect on inflation.

Some think that, instead of using the chief weapon in its arsenal, the Bank should use other means, primarily the reserve requirements. But changing reserve requirements is an obsolete measure that would have a limited and unpredictable effect apart from raising interest rates. After Iceland's banks were privatised and their international operations began to grow, it was inevitable that reserve requirements here should be similar to those in other countries; otherwise, the competitive position of Iceland's financial institutions would be quite different – and poorer – than that of their competitors. In developed countries, central banks no longer use the reserve requirement as a tool to combat inflation.

It has been said that the Central Bank's problem is that it is looking in the rear-view mirror when it makes its decisions, whatever that might mean. It is true, of course, that the Central Bank looks both at the present and the past when it examines indicators of likely future developments. There is no other way to forecast future developments intelligently than to examine the indicators from the recent past, apply to them the metrics that the copious experience from Iceland and abroad has taught us to use, and to use both indicators and metrics as a guideline in projecting future developments. If we didn't use this method, there would only be one left: to pour tea into a cup, turn it upside down, and read the tea leaves when the saucer is dry. The Central Bank has no comment to make on those who wish to pursue that course, but it isn't likely to be terribly successful.

When the Central Bank announced its interest rate decision, it stated that several factors that have made inflation harder to control could change over time. Sooner or later, higher mortgage interest rates will affect the real estate market. Global financial market conditions have changed for the worse. Those changes are already being felt, and sooner or later they will be felt in Iceland as well. In its forecasting, the Bank takes these factors into account, and it does not rule out the possibility that their actual impact will be greater than projected. Many people hoped that the unrest in the financial markets, which stems largely from the subprime mortgage market in the US, would blow over rather quickly. Some even seemed to believe that a modest drop in US interest rates would be sufficient to coax everything back into place once again. But by now most have realised how unlikely these problems are to disappear so quickly. There is every reason to believe that the coming months could prove difficult as a result, and there is correspondingly little reason to believe that the crisis is past. Uncertainty abounds. A huge investment bank like Merrill Lynch could not foresee that, in only two weeks' time, it would have to write down billions of dollars' worth of outstanding debt. The CEO of the company has had to pack his bags and leave, albeit with a generous going-away present. The largest bank in the world is also beset by the restlessness, and it isn't yet fully clear what the effects will be, but that CEO has received his marching orders as well. And according to the latest reports, while there are reported write-downs of a mere 20 billion dollars on subprime mortgages, the actual amount could in the end be between 250 and 300 billion.

One cannot help but wonder whether market participants in Iceland and elsewhere preferred to suffer through a shaky third quarter in the hope of some redemption in the fourth quarter, and in the process, avoided recording some items that should have appeared in third-quarter accounts. No one is going so far as to allege that the global markets are besieged by a broad-based movement to violate the law or act contrary to ethical business practice, but it could nonetheless be that the rules are stretched quite a bit, though perhaps within the limits of legality and even ethics. In so doing, companies everywhere are factoring in the value of assets for which there is, at present, no market. To be sure, assessing the market value of assets that are not marketable, either for the short term or for the long term, is a tricky matter. In the vast majority of cases, a market will develop at a later date, and if the companies in question have the wherewithal to hold them until that market develops, there is no reason to harbour any real anxiety. But assets that end up at a fire sale are another matter entirely. So it is difficult to determine market value when the market is sticky and virtually closed. All of these conditions kindle suspicions and undermine faith, and as it seems, the real problem is not so much a growing lack of liquidity as a growing lack of faith. The sooner trust and faith begin to grow again in world markets, the sooner they will rise up from this slump, or recession – at the moment we don't know which term is more appropriate.

Many things are changing, both in Iceland and elsewhere. A new edition of the book "Ten Little Negroes" causes ripples of unrest. Of course, there is no reason to ban books, but the unrest caused by this book is actually a positive thing. It is a sign of changing times, enhanced understanding, and diminishing prejudice. When that book was published in the mid-20th century, hardly anyone thought of it as being hurtful or offensive in any way. But now we see that it can indeed be those things, and this is why the publication of the book and the ensuing discussion are a positive indication of new times and changed perspective. Actually, recent decades have seen a fervent effort to recast well-known terms and names for all sorts of phenomena so as to avoid injuring those who, either temporarily or for the long term, might be vulnerable. This is also positive, though some of these philanthropic efforts have gone a bit too far in their enthusiasm. Another phenomenon we see is that newly coined terms soon become cloaked in a sort of semi-divinity in Iceland – like the term "international expansion," which no one dares oppose lest he be accused of being an anachronism, devoid of a sense of "vision," as it is now called, and of not knowing when the time is ripe for action.

Upon closer scrutiny, the term "international expansion" seems to be nothing more than investment abroad – together with utilisation of knowledge and talent, of course. In that sense, the construction of the aluminium smelter in Reydarfjördur can be called Alcoa's international expansion into Iceland, though no one has bothered to call it that. But it is: it is investment combined with the utilisation of knowledge of the aluminium industry. That expansion is promising in many ways, of course, and some aspects of it have already generated substantial returns, not least because people took advantage of favourable conditions and external circumstances. For a while, cheap capital was readily available, and some were bold enough to grab the opportunity. But the flip side of expansion, and the side that cannot be ignored, is that Iceland is becoming uncomfortably beleaguered by foreign debt. At a time when the Icelandic government has rapidly reduced its debt and the Central Bank's foreign and domestic assets have increased dramatically, other foreign commitments have increased so much that the first two pale into insignificance in comparison. All can still go well, but we are surely at the outer limits of what we can sustain for the long term.

The term "international expansion" is so thoroughly bathed in radiance that even when people seem to be invading companies that are owned by the public, the invasion is called "expansion". And companies whose primary obligation, by law and by the nature of their operations, is to provide the public with specific services at the lowest price possible, suddenly find themselves participating in foreign risk ventures without there having been any rational discussion of the matter beforehand – and all in the name of "international expansion." In matters such as this, we must proceed with the utmost caution.

We Icelanders have been successful in our endeavours in the recent past, and we have had the wit to be careful when necessary, but it would be imbecilic to believe that we can loosen our belts – that is, if we want to continue being successful. One of the ways in which we must remain vigilant is to refuse to allow inflation to gain a foothold in our economy. All attempts to dodge this responsibility will harm the Icelandic people, with unforeseeable consequences. We must not increase our foreign debt beyond its current limits – on the contrary, it is right and necessary that we reduce our foreign debt and achieve a more favourable balance with abroad. Plans for international expansion must therefore be carried out within sensible limits. The immoderate zeal that is so intoxicating may not be allowed to steer our course for the future. We know that, in many ways, our upward climb rests on a bed of clouds. To some extent, this is inevitable, and it is normal that items like intangible assets should be prominent in good times; but when the sky darkens and the clouds become heavy, the rain can start at a moment's notice, and little may be left of those assets when the air clears. So we must take care in this as well as in other things.

By law, the Central Bank of Iceland is assigned a clearly defined role. The Bank takes that role very seriously. It does not ask to be spared criticism of its work and its decisions, but it would appreciate some support in its attempt to keep inflation within tolerable limits. If we are successful in that endeavour, all Icelanders will benefit. If we all work together, we can reduce interest rates sooner and more quickly.