Mr Gunnarsson touches on a number of topics including developments in the Icelandic economy, the financial system and financial supervision

Presentation by Mr Birgir Ísleifur Gunnarsson, Governor and Chairman of the Board of Governors of the Central Bank of Iceland, to the Iceland Finance Forum held in Íslandsbanki HF on 22 October 1999.

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Mr Chairman, Ladies and Gentlemen,

I am honoured to have the opportunity to address such a distinguished gathering of financial professionals and I congratulate Íslandsbanki for having brought you all together in Reykjavík. In my talk today I will touch on developments in our economy, developments in the financial system, the monetary policy of the Central Bank of Iceland, financial supervision and the implications of developments in Europe.

Economic developments

A strong upswing has characterised the Icelandic economy in recent years. We are now in the fourth year of more than 5% real growth of the economy. In the early phase of the upswing, growth was driven to an important extent by a strong recovery in foreign direct investment in Iceland, particularly in the so-called power intensive industries. Later on, rising domestic consumption became the driving force of economic growth. From the early part of the decade, inflation was very low. For a number of years it was in fact consistently lower than the average for the OECD countries. The rapid growth of recent years has brought the economy to full capacity, the unemployment rate has fallen below 1½%, resulting in substantial wage pressures in certain segments of the market. The sharp expansion has resulted in a rising rate of inflation. In the 12 months to the beginning of October, consumer prices rose by 5.3%. The Central Bank issues inflation forecasts every three months. The latest forecast was issued in July and it envisaged a 3% average rate of inflation in 1999 and a 4% inflation rate from the beginning to the end of the year. A new forecast will be issued in the beginning of next week. The deficit on the current account of the balance of payments has risen. In 1998 it equalled roughly 5½% of GDP. It is expected to be lower in 1999.

During the upswing, the Central Bank of Iceland has followed a restrictive monetary policy as reflected among other things in the fact that at present the differential between Icelandic and trade weighted foreign money market rates is well in excess of 5%. The yield on 3-month treasury bills in the market is currently above 9%, and the so-called repo rate of the Central Bank of Iceland is 9%. That can be compared with the repo rate of the European Central Bank of 2.5%.

Since September of last year, the Central Bank has raised its interest rates four times, by a total of 1.8 percentage points. In early 1999 it also levied a liquidity requirement on Icelandic credit institutions. The requirement is primarily prudential in nature. It was among other things aimed at reducing the reliance of domestic credit institutions on foreign short-term capital to finance their domestic lending activities which had risen sharply, but has subsequently diminished markedly.

Low inflation and macro-economic stability was only achieved in the early part of this decade. Consequently, it is not at all surprising that we have to maintain interest rates that are significantly higher than among our main trading partners. The required difference is variable over time, depending among other things on the credibility of economic policy, relative cyclical positions and so on. The current differential is the widest since capital movements were liberalised and is of course explained to an important extent by the very different cyclical position of the Icelandic economy from that of most of our trading partners, not the least in Europe. It also entails the cost of maintaining an own currency, i.e. a premium for the availability of the exchange rate as an instrument.

In this connection, I should also note that since the opening up of the capital account of the balance of payments, long-term interest rates, which used to be very high by any comparison, have been on a downward trend despite repeated increases in short term rates. This is not surprising and reflects a narrowing of long term interest rate differentials between Iceland and other countries towards a much lower level than prevailed before capital movements were liberalised.

Two years ago the fiscal budget turned into surplus. That surplus has risen and in the budget proposal for the year 2000, which was submitted to Parliament at the beginning of this month, the envisaged revenue surplus is equal to 2.2% of GDP. In the view of the Central Bank, it is essential that the targeted budget surplus be realised. It is important for the credibility of the overall policy of the government and because it will have dampening effects on domestic demand and thus reduce the current account deficit.

The foundations of the Icelandic economy have strengthened in recent years through effective natural resource management and increased diversification, including the expansion of services exports. Iceland has made great strides in economic management as indicated by the stability and favourable economic developments that have characterised the economy for much of this decade. Instrumental in the changes that have taken place has been the liberalisation, and I might say marketisation, of the economy.

In our present situation it is of paramount importance to safeguard the stability of the economy and quickly reduce inflation again. The Central Bank will continue to pursue a monetary policy geared to that end.

Credit rating

The success in economic management did not escape the attention of the rating agencies. The Republic of Iceland was first assigned a rating by Standard & Poor’s and Moody’s in the late 1980s. The initial long-term rating from both agencies was in the middle of the single A category. In 1996, both agencies raised Iceland’s rating by one notch and in 1997 Moody’s raised Iceland’s rating again and that time into the double A category, to Aa3. The short-term rating is A-1+ and P-1. Both agencies have assigned ratings to the long-term obligations of the Republic of Iceland in domestic currency, Aaa and AA+. The improved rating demonstrated a welcomed recognition of the progress made in Icelandic economic management in recent years. In our own view, the rating improvements were overdue, first because our economic performance was in quantitative terms fully compatible with that of countries with a higher rating than Iceland, and, secondly, because it seemed obvious that the reception of Icelandic borrowing operations in the markets indicated that financial institutions have consistently assessed Icelandic risk differently from, or one might say more favourably than, the rating agencies.

Structural changes

Other speakers at this conference will touch on structural changes in the economy, particularly in the financial sector. I only wish to emphasise that it is not an overstatement to say that the Icelandic financial system has undergone radical changes since the middle of the 1980s. The market was deregulated, a stock exchange was established, and new institutions and financial services flourished. Last but not least, all restrictions on the movement of portfolio capital between Iceland and other countries were removed as alluded to earlier. The market is now similar to that in other developed countries, except for volume of course, while the role of the government through ownership of financial institutions stands out. The privatisation process is under way and there is room for considerable improvements in efficiency in the financial sector. One should expect mergers of individual institutions to take place in the period ahead. Competition among domestic financial institutions is fierce.

In the rest of the economy, significant efficiency gains have been realised through privatisation of state enterprises and mergers of companies into larger and more efficient units.

Our experience since capital movements were fully liberalised shows us clearly that foreign exchange flows are very sensitive to changes in the short-term interest rate differential between Iceland and other countries. More generally, the volume of capital flows between Iceland and other countries has grown substantially. It has mainly been a one-way street, though, as domestic portfolio investors have been much more keen to invest abroad than foreign investors to invest in Iceland. On the domestic side, the pension funds have, since capital movements were liberalised, invested substantial amounts in foreign securities. Foreign assets of pension funds now exceed 15% of their total assets as compared with virtually nothing only five years ago. These assets are now yielding noticeable returns in our balance of payments.

There are undoubtedly several reasons why foreign portfolio investors have only shown limited interest in Iceland. These include the relatively limited size and depth of the market and the fact that securities are not yet electronically registered. This will change in a few months' time when a central electronic securities registry will commence operations.

Touching briefly on the stock market, equity trading in Iceland has risen very rapidly in recent years, as has the number of publicly listed companies and their total market capitalisation. Among other things, the depth of the market is increasing because of the incorporation and privatisation of public enterprises, including the banks. The laws and regulations pertaining to the stock market, including disclosure requirements, are similar to those in other European countries.

The conduct of monetary policy

Turning more specifically to the Central Bank of Iceland and the conduct of monetary policy, the current legislation stipulates many goals for the Bank. With the liberalisation of financial markets and the opening up of the capital account, as well as with international developments towards greater independence for central banks and simplified policy targets, the main target of the Central Bank of Iceland has gradually become that of maintaining a low rate of inflation. The Bank has also gained greater independence than is strictly provided for in the current law, which it has achieved with the tacit approval of the Government, but partly in agreements on specific aspects. In my view, this is important for enhancing the credibility of monetary policy and the Central Bank. Credibility is very fragile and it takes strong effort and careful policy and policy implementation to enhance and maintain it. Another objective of the Central Bank is to monitor the stability of the financial system.

The Central Bank has been active in promoting the development of the financial system and financial markets in Iceland and we have sought to adopt the methods of monetary management that have been developed in other advanced industrial countries. In 1998, we modified the instruments and operating procedures of the Central Bank along the lines that had been developed for the future European Central Bank. The Central Bank of Iceland levies a reserve requirement on credit institutions, operates an overnight facility and offers a deposit facility. The main operating instrument of the Bank is the repo rate. Auctions of 14 day repo contracts are conducted once a week. By adjusting our instruments and methods, we created a similar operating environment for Icelandic banks as those that prevail for banks in the Economic and Monetary Union of Europe. I should add that we are in the process of adapting our payments and settlement systems to the norms of our neighbouring countries. This includes, among other things, the establishment of an RTGS system for large-value payments.

I mentioned that the main target of the Central Bank is the maintenance of low inflation. That is a long-term target. Our intermediate target is a fixed exchange rate. A more appropriate description of our exchange rate policy is to refer to it as a fixed but adjustable peg. Since 1995 we have operated with a fluctuation band around the central rate of plus/minus 6%. In practice, the Central Bank has allowed the exchange rate to move within the band to the extent that it deems such movements consistent with its long-term goal of maintaining low inflation. Now the exchange rate is roughly 3.5% above the central rate and has appreciated by 2.7% since the middle of June when the Central Bank raised interest rates for the second time this year.

In our present situation, we have sought to increase the transparency of our operations by explaining as thoroughly as we can the targets of monetary policy, our instruments, our methods, the assessments that underlie our policy in general and our individual actions in particular. This we do through our regular publications and interviews with the press. This is important in order to broaden the understanding of the main principles which underlie our monetary policy and its implementation.

Financial supervision

As you may know, until the end of last year, the Central Bank was responsible for the supervision of the operations of all financial institutions in Iceland except insurance companies. At the beginning of 1999, the Bank Inspectorate of the Central Bank and the Insurance Supervision Authority were merged into a new Financial Supervisory Authority which has the responsibility for supervising the operations of all financial institutions in Iceland. The change was in a way modelled on decisions which had been taken in some other countries, such as the United Kingdom. The new supervisory authority is governed by a three-member Board of Directors appointed by the Minister of Commerce. One of the three members is appointed on the recommendation of the Central Bank.

Several years ago, we introduced the so-called Basel equity ratio standards for our financial institutions. Being a signatory to the European Economic Area Agreement, Iceland was obliged to adopt European Union financial market legislation based on European Union Directives which has been done. As a result, we have created virtually the same legal environment for our financial system as that of the European Union. Supervisory practices are also similar to those followed in the member countries of the European Union.

The Central Bank has been developing its own methods of assessing financial market stability and indicators of weaknesses, focusing more on the overall health of the financial system than that of individual institutions which falls under the Financial Supervisory Authority.

Iceland and Europe

Iceland has never applied for membership in the European Union and at present there are no plans to do so. Iceland is, however, a member of the European Economic Area, which means that it is a part of the single market of the European Union, entailing *inter alia* the free flow of goods, services, capital and labour among the member countries. Under the European Economic Area Agreement, Iceland has been obliged to adopt European Union legislation in many areas, as already mentioned.

The Central Bank has established close contacts with the European Central Bank in Frankfurt. Given the fact that Iceland is not a member of the European Union, membership in EMU is out of the question. Nevertheless, the establishment of EMU will affect Iceland, particularly in the longer term. A few facts may be mentioned: first, the European Union is an important trading partner, but the absence of Denmark, Sweden and the UK from the EMU means that only about a third of our external trade is with EMU countries at present. Once the three countries join EMU, which we expect them to do, the share of EMU countries in our external trade will rise to above 60%. Second, we expect that our economic performance will be measured by the markets against the criteria developed for the EMU countries. Third, we expect that a successful EMU will bring beneficial effects to Iceland in the form of increased demand for our exports and reduced transaction cost in external trade. Fourth, it might become a greater challenge to operate our own currency. One could, for example, envisage that a currency like ours would be increasingly subjected to pressures from international investors seeking to diversify portfolios, adding currencies on the edge of the euro area and closely linked to it. This could conceivably lead to increased volatility and consequent potential instability down the road.

The immediate effects on Iceland of the establishment of the EMU have not been significant. However, the entry of Denmark, the United Kingdom and Sweden into the EMU will markedly change our situation. As time goes by, we will have to consider our options. A review of our future exchange rate policy will be particularly important. The possibility of Iceland at some stage joining a larger currency area should not be precluded, particularly if the political and economic cost of staying outside will be found to outweigh any advantage of maintaining an own currency.

Iceland and America

Looking briefly in another direction, Iceland's relations with the great continent in the West date back a thousand years. In recent decades, we have had important trade links with the United States. However, the relative share of trade with the US has declined significantly, or below 15%, since exports to the US peaked at almost 30% of total exports in the 1970s. Imports from the US also declined significantly from a high level around the middle of the century to around 10% of total imports in the most recent years. The number of American tourists has also declined in relative terms. Although the share of the US in Icelandic merchandise trade and tourism has declined, the US dollar still plays a significant role as a vehicle currency in Icelandic trade and foreign exchange transactions. Recent changes in the geographical pattern of trade and investment reflect the liberalisation of trade within Europe and the increasing globalisation of the world economy. Like other developed countries, Iceland has a most favoured nations agreement with the US and Canada. Recently, there have been negotiations between Canada and the EFTA countries on a free trade agreement and a similar agreement with Mexico has been discussed. If an agreement is reached the share of NAFTA countries in trade and investment could increase.

Given Iceland's membership in the European Economic Area and consequent tariff-free access to the European Union, Iceland offers a unique opportunity for foreign direct investment from non-European investors, including of course American ones.

Concluding remarks

To conclude, I would like to emphasise the importance which I attach to the liberalisation and opening up of the economy in recent years. The market is a strict master and provides strong discipline for economic policy. There is little doubt that Iceland is today reaping the benefits of general liberalisation. At present, we are also for the first time after the opening up of the capital account facing a challenge posed by the threat of overheating in the economy. Our policies and policy tools are being put to a test.