Birgir Ísleifur Gunnarsson: Monetary policy, economic growth and prosperity

Opening address by Mr Birgir Ísleifur Gunnarsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a conference to mark the 60th anniversary of the University of Iceland Faculty of Economics and Business Administration, Reykjavik, 31 October 2001.

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I would like to congratulate the University of Iceland's Faculty of Economics and Business Administration on its 60th anniversary, its noteworthy activities and its contributions towards strengthening the Icelandic economy. I also wish the faculty every success for the future. At the same time I thank you for the honour I have been shown with this invitation to deliver the opening address at this anniversary conference.

I have chosen to call my talk "Monetary policy, economic growth and prosperity." I shall therefore focus on the role played by monetary policy in economic policy implementation, and its contribution towards economic growth and prosperity. And there is ample reason as well, because the most notable events in economic organisation this year have involved precisely the monetary policy framework and the Central Bank.

Price stability

Important changes have been made to central bank legislation around the world in recent years. There has been a gradual increase in support for the view that it is natural to set central banks straightforward targets which are suited to the instruments they use, and to strengthen their independence to take action and their financial independence while at the same time making firm requirements about transparency and accountability towards the government and general public. Treasury access to central bank funding was closed. Simple target-setting for central banks largely involved assigning a single main objective to monetary policy, i.e. to promote price stability, which means a low level of measured inflation. In some countries, central banks were assigned the task of defining their own main objectives, but elsewhere this was done by governments, or in cooperation between the government and the central bank. These viewpoints are reflected in central bank legislation of many countries and in the Maastricht Treaty's provisions for the establishment and activities of the European Central Bank.

Another widespread central bank objective in recent years has been to contribute to the stability of the financial system, including payments systems. Many central banks have been devoting increasingly more scope to this topic, reflecting the need which has been identified following the deregulation of international capital movements. At global level, a much higher profile has been given to active monitoring of financial activities and maintaining an active overview of various risk factors in financial systems and the economy as a whole, in order to attempt to prevent serious shocks.

Persistent inflation is the result of lax monetary stance

There are good reasons for assigning central banks a single main objective, namely to promote price stability. Inflation is primarily a monetary phenomenon. Short-lived inflation can have many causes, but persistent inflation is the consequence of a lax monetary stance. In the long run, monetary policy therefore primarily has an effect on prices. Under normal conditions it only has a temporary impact on economic growth and employment. Since central banks broadly speaking have only one instrument, i.e. interest rates, and can therefore only achieve a single long-term macroeconomic goal, it is natural to set price stability as the ultimate monetary goal. This is not to say that price stability is a more important goal than, say, full employment, but simply that monetary policy instruments are inherently better suited to impacting prices. It is pointless to set objectives for monetary policy which it cannot achieve. Through price stability, a forward-orientated monetary policy can contribute towards creating a stable economic environment on which the long-term growth potential of the economy, namely growth and prosperity, is based.

The reason that central banks can have a widespread effect on interest rate formation in the markets through their interest rate decisions is that they have the exclusive right to issue money in the economy, i.e. base money. By controlling the price of base money, i.e. the interest terms at which financial institutions can borrow short-term capital from them, central banks can influence the volume and price of liquidity in the financial system. Central Bank interest rate decisions have an impact on short- and long-term interest rates, financial system liquidity, money in circulation and bank lending, exchange rates of currencies, other asset prices and, last but not least, market participants' expectations about the future development of all these factors. All this, in turn, influences consumption and investment decisions of individuals and businesses, and thereby aggregate demand. The impact in individual areas can vary greatly from one time to the next.

The new Central Bank Act

The previous Central Bank Act dated from 1986 and was drafted over the period 1981 to 1984. It was a product of its time and did not reflect the perspectives that later established themselves. In the early 1990s the then Minister of Commerce appointed a committee to review the Central Bank Act, chaired by Professor Ágúst Einarsson, the current Dean of the Faculty of Economics and Business Administration. Following the committee's work the Minister of Commerce proposed a bill to parliament for a new Central Bank Act which entailed sweeping changes from the 1986 Act, including what are now considered to be many of the necessary elements of central bank legislation. However, the bill was not adopted by parliament.

In May this year parliament passed a new Central Bank Act with the approval of all 56 members who were present for voting on the bill. A detailed account of the main changes from earlier legislation has been given in the Central Bank's publications. See i.a. the Central Bank of Iceland's Monetary Bulletin 2001/3 I shall only mention here that a single target was set for the Central Bank, i.e. to promote price stability. With the Prime Minister's approval, the Bank was also authorised to specify a numerical inflationary target. The Bank was granted full independence to apply its instruments in order to achieve its main objective. Its financial independence was increased by precluding in law treasury access to short-term funding with the Central Bank, which had previously been precluded with an agreement between the Minister of Finance and the Bank. Provisions on transparency and accountability towards the Government and general public were made more focused.

As I mentioned before, one of the Central Bank's main objectives is to contribute towards an active and secure financial system, or financial stability as it is often known. In recent years central banks in many countries have been increasingly devoting themselves to monitoring financial stability. This development is partly the product of financial market liberalisation and the deregulation of capital movements, and partly a response to shocks which have struck many countries, both currency shocks and banking system setbacks. Examples include the troubles encountered by banks in Finland, Norway and Sweden a decade ago and the crises that hit Asia and Latin America in the latter part of the 1990s. The Central Bank of Iceland has now built up a new organisational department, the Financial Stability Department, which has the main role of monitoring factors affecting financial stability. Twice a year the Bank publishes articles on this topic in its quarterly *Monetary Bulletin*, an annual main study in May and a shorter account in November. In addition, the Central Bank and Financial Supervisory Authority maintain close and productive cooperation, each seeking to ensure the security of the Icelandic financial system in its respective way.

Inflation targeting

To return to monetary policy itself, we should recall the joint declaration on the inflation target and changed monetary policy which was issued on March 27 by the Government and the Central Bank of Iceland. See the Central Bank of Iceland's Monetary Bulletin 2001/2 With this declaration, the monetary framework was changed and inflation targeting was adopted, whereby the fixed exchange rate with fluctuation limits was replaced by a floating exchange rate. The inflation target was set at 2½%, measured as the twelve-month rise in the CPI. The declaration stated that if inflation deviated by more than 1½% from this target the Bank was obliged to bring it back within the tolerance limits as soon as possible. At the same time the Bank would be obliged to submit a report to the Government, which would be made public, stating the reason for the deviation, its planned response and the length of time that it expected to take to bring inflation back within the range. Since inflation was somewhat above the target when the declaration was made, the upper tolerance limit was set for 6% in 2001 and 4½% in 2002. Despite the abolition of the exchange rate fluctuation range, the Central Bank reserved the right to intervene in the interbank market for foreign exchange by buying and selling currency if it deemed this necessary in order to contribute towards attaining the inflation target, or if it viewed exchange rate swings as a threat to financial stability. In effect, this new policy was ratified with the new Central Bank Act.

The inflation target policy makes great professional demands upon the Central Bank. Although it was introduced at fairly short notice, the Bank had prepared itself for a conceivable change in the monetary framework for some time beforehand. An important aspect of the new policy is the Bank's commitment to produce and publish inflation forecasts four times a year, projecting at least two years ahead. The Bank already had considerable experience of inflation forecasting and our studies have shown that it is no less capable in this field than other central banks that follow comparable policies. This success has been achieved through ambitious professional and theoretical work which is one of the Bank's main focuses. We became aware that other central banks following the same kind of policy had noted and commented on how carefully Iceland had prepared for the introduction of inflation targeting. It is aimed to strengthen the Central Bank's research and theoretical work still further, and it is worth pointing out that the new legislation specifically states that it should undertake economic research relating to its tasks.

Inflation targeting establishes itself

Inflation targeting policies have established themselves in recent years, with a correspondingly large reduction in the number of countries which apply policies based on fixed but adjustable exchange rates, or exchange rates within a fluctuation range. The reason is not least that it proved increasingly difficult to adhere to a fixed exchange rate policy in a world of deregulated capital movements. It could be said that prevailing opinion identified only two possible exchange rate options: a floating exchange rate or a completely fixed one, for example through membership of a currency union, unilateral adoption of some other currency or establishment of a currency board. The new policy has produced good results and is applied in countries including Sweden, Norway, the UK, Australia and New Zealand, along with several countries in Eastern Europe, Latin America, Asia and Africa. It can also be argued that the European Central Bank partly follows the same kind of policy.

From all the above it is clear that the Central Bank of Iceland has undertaken the major responsibility of ensuring price stability, which in the sense used in the joint declaration by the Government and Central Bank means a twelve-month rise in the CPI of 2½%. It is not the Central Bank's role to ensure a specific rate of growth or level of employment, since its instruments are incapable of having any impact on them in the long run. However, it is acknowledged that ensuring price stability creates vital preconditions for economic growth and prosperity.

Inflation increased substantially this year and in June it passed outside the tolerance limits as defined in the March declaration. According to the Central Bank's inflation forecast published in early August, the outlook that inflation would rapidly decelerate towards the end of this year and the beginning of the next, then would move inside the tolerance limits in the middle of next year, and the 2½% target would be reached in mid-2003. The forecast was based on the main assumptions of an unchanged exchange rate from the forecast day, a cooling of the economy and no wage rises in excess of agreements that had already been negotiated. The Central Bank will publish its next inflation forecast on November 8.

Tight monetary stance

The Central Bank has applied a tight monetary stance for some time now, as reflected in its high policy interest rate. The policy rate is the rate of interest applying to the Central Bank's repo transactions with credit institutions, i.e. interest on liquid funds that they borrow from the Bank. Monetary policy has been the subject of lively debate in recent weeks and months and the Bank has been under steady pressure to cut interest rates. As the Central Bank has repeatedly underlined, its viewpoint has been that lowering interest rates entails a greater risk than waiting for a while for tangible signs that the assumptions behind the August inflation forecast will hold good. It is crucial to bring inflation down swiftly, since it goes without saying that inflation is the worst enemy of both households and businesses. A tight monetary stance inevitably has consequences which are sometimes painful for households and businesses. There is nothing to be done about that. Households and businesses alike must accept the consequences of their actions and it is obvious that many of them have simply gone to excesses in their consumption, investments and borrowing in recent years. They will need to reduce their spending, cut costs and put their finances in order. That cannot be avoided.

I also point out that the current account deficit is very large. Even though it has shrunk rapidly this year and will foreseeably continue to decrease substantially next year, it is still very large both in a historical and an international context. In order to achieve acceptable macroeconomic balance, a contraction in national income is unavoidable. Lower inflation and improved macroeconomic balance will also create a climate in which the nominal exchange rate of the króna can begin to appreciate.

Furthermore, I underline that interest rates definitely do have the same effect in Iceland as in other countries, and that our research and studies indicate beyond any doubt that the impact of monetary policy in Iceland is similar to that elsewhere. However, people need to understand exactly what monetary policy is capable of, and what it is not.

Transparency

Finally, I shall turn to issues which are no less important than those I have already mentioned. Greater central bank independence in recent years has been accompanied by much more stringent requirements about transparency and accountability towards the government and general public. This means that central banks should operate as openly as possible. They must give clear accounts of their policies and assessments of the economic and monetary situation and outlook, and explain in detail the assumptions underlying their monetary decisions. All this serves the purpose of informing the government and public as fully as possible about monetary policy, providing them with a basis for understanding it and, depending on the circumstances, making an independent evaluation of it. One way in which the Central Bank fulfils this function is with the publication of its quarterly *Monetary Bulletin*. Indeed, the new legislation states that the Central Bank shall, at no less frequent than quarterly intervals, publish reports on its monetary policy and monetary, exchange rate and foreign exchange developments and its measures in these areas. The Central Bank shall also issue an annual report in which it explains in detail its activities. In its annual report, the Bank outlines various other aspects of its operations and publishes a detailed itemised account of its operating expenses, more detailed, I believe, than any other institution in Iceland. To cite an example of the importance of transparency these days, in autumn 1999 the International Monetary Fund published guidelines for transparency of monetary policy which it firmly urged all member countries to adopt. The Central Bank of Iceland can definitely be said to fulfil these rules.

By providing detailed descriptions of its policies and assessments of the economic and monetary situation and outlook, the Bank also contributes to professional and informed public debate on these issues. By the same token, greater responsibility is imposed on other commentators, since they have less scope for claiming lack of information. The Central Bank wholeheartedly welcomes professional public debate about the Bank and its policies, and takes part in such dialogue where it sees grounds for doing so. Lively, professional dialogue produces even greater understanding of the character and objectives of monetary policy. I hope to see students and teachers at the Faculty of Economics and Business Administration becoming involved in these issues in the future. There is always scope for new opinions in debates on current affairs. The debate in recent weeks partly reflects the fact that people are still absorbing the major changes that were made to the monetary policy framework this year.

A wide range of cooperation has taken place between the Central Bank and the University of Iceland in recent years. The Central Bank has supported research projects in its areas of activity, and published the findings in its journals. As the importance of monetary policy becomes increasingly recognised in economic policy implementation, it is vital for the University's Faculty of Economics and Business Administration to give a high profile to monetary economics, both theoretical and practical. Monetary policy is transmitted through numerous markets and it is vital for people engaged on both the analytical and business sides to have a firm grounding in this field. Similarly, it is important for the dialogue on monetary policy to be conducted as far as possible on a firm professional basis. The Central Bank is eager to cooperate more closely with the faculty and other bodies on strengthening university level teaching in monetary economics and central banking.

Ladies and Gentlemen:

In this talk I have described the changes made in Iceland's monetary policy implementation and new attitudes to monetary policy in much of the world. The main task of most central banks is to promote price stability, because it is recognised that by doing so they make the best contribution to economic growth and prosperity. Under the new monetary framework, the Central Bank of Iceland has been provided with the same mechanisms as central banks in most industrialised countries for creating such an environment. The Central Bank takes this role seriously and will strive to fulfil the conditions laid down by the new legislation and in the joint declaration which it issued with the Government on March 27.

The global economic climate has been dramatically transformed in recent years and is still changing in the wake of the terrorist attacks on the USA on September 11. It is quite obvious that we in Iceland do not carry much weight in global economic terms. However, the situation in our immediate environment, especially among our main trading partner countries, is crucial to us. At the moment we are having a somewhat stormy ride. In this new environment, the role of everyone involved in economic policy-making in Iceland will be to act in a disciplined and responsible fashion. Doing so will be the main way to contribute to economic growth and prosperity in Iceland.