Birgir Ísleifur Gunnarsson: Monetary issues in the European Union and Iceland

Speech by Mr Birgir Ísleifur Gunnarsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a seminar organised by the Iceland Trade Council, Euro Info office in Iceland and the EU Commission on the theme: Does the Euro affect Iceland?, Reykjavik, 31 October 2001.

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Ladies and Gentlemen:

The evolution of European integration during the second half of the last century is remarkable in many ways. This process began soon after the end of World War II and represented an effort to forge stronger bonds between European nations and thereby, among other things, reduce the likelihood of further conflict on the continent. Although I shall not go into its history here, many notable milestones can be cited along the course that has been taken. One of the most notable was the formal establishment of the Economic and Monetary Union in the beginning of 1999. Now the abolition of the individual member nations' separate currencies is in sight. As of next year they will be replaced by Euro notes and coin. Not only will prices of goods and services be calculated and stated in a single currency in the twelve EMU countries, but the same notes and coin will be used for business in them all. One consequence of pricing in a single currency in all member countries will be to facilitate buyers of goods and services greatly in making price comparisons, and competition within the EU will certainly become more active than it has been until now.

Economic and Monetary Union

The EMU has a population of more than 300 million and accounts for 16% of global GDP. By way of comparison, the USA has a population of 280 million and accounts for 22% of global GDP. Exports of goods and services are equivalent to 19% of EMU GDP, while the corresponding figure for the USA is under 11%. Some 19% of total world merchandise exports come from the EMU, and 15% from the USA.

Twelve of the fifteen EU nations belong to the EMU. The UK, Denmark and Sweden remain outside it, but their positions differ somewhat. Denmark and the UK have stated reservations about membership, on which they have reached agreement with other EU states. Sweden, on the other hand, has opted to remain outside the EMU, although no special reservations have been agreed upon for them. Denmark is involved in currency cooperation with the EMU, one aspect of which is that the exchange rate of the Danish krone may not deviate from the Euro by more than 2.25% from a defined central rate. Denmark therefore enjoys limited monetary independence. This is reflected in the fact that the Danish Central Bank invariably alters its interest rates in the wake of announcements of changes in the European Central Bank (ECB) policy rate. Sweden and the UK have opted for inflation targeting as their monetary policy framework, which therefore does not have the objective of keeping these countries' currencies stable against the Euro.

European Central Bank

The Maastricht Treaty stipulates monetary arrangements in the EMU. The EU countries created a framework for the ECB's activities which was to some extent modelled on the Central Bank of Germany but differed in many ways from the arrangements in others. Various conditions were set which EU members had to fulfil in order to be granted EMU membership. On the one hand these related to major components of economic developments, such as inflation, fiscal deficit, government debt and interest rates. On the other hand they addressed the framework that the Maastricht Treaty lays down for monetary policy implementation in the EMU.

This policy was consistent with growing support for the view that it was natural to set a simple target for central banks – i.e. promoting price stability – and to increase their independence from the political leadership in pursuing their main objectives, and to strengthen their financial independence. Another emphasis was that, at the same time as the central banks' independence was strengthened, stricter demands would need to be made of them regarding transparency in their activities and actions, and regarding accountability towards the government and general public.

All this was reflected in the Maastricht Treaty. The European Central Bank, which formally began operation in the middle of 1998, enjoys extensive independence and is subject to requirements for transparency and accountability. Even though Sweden is not yet a member of the EMU, it amended legislation on its own Central Bank which now largely fulfils the Maastricht terms. The Bank of England's legislation does not entirely fulfil the terms of the treaty, but it was granted greatly increased independence a few years ago. Denmark has still not amended its central bank legislation, although this will need to be done in the event of Denmark joining the EMU, not least to give legal sanction to its independence.

Price stability is the main objective

The Maastricht Treaty set a single objective for the European Central Bank, namely ensuring price stability. Price stability was not defined in the treaty, however; this was done by the ECB itself, which specified it as an annual rise of under 2% in the Harmonised Consumer Price Index. A separate treaty on stability and economic growth stipulates that EMU members should aim for long-term fiscal balance or a surplus, and a public sector deficit of less than 3% of GDP.

The decisive viewpoints behind the formulation of the European monetary framework were also dominant in many other parts of the world. Examples are industrialised nations such as Australia and New Zealand, while numerous others, such as the transformation economies of Eastern Europe and newly industrialised countries in Latin America and Asia amended their legislation to reflect the main principles of simple target-setting, independence and transparency.

Even though Iceland was not a party to European monetary cooperation and there was no outlook for a change in this situation for the foreseeable future, the Central Bank of Iceland felt that it ought to monitor developments as closely as possible. The forerunner of the ECB, the European Monetary Institute, was founded in the beginning of 1994 and the Central Bank of Iceland soon established formal relations with it. This continued after the ECB began operation. Central Bank experts have also had ready access to ECB experts on various issues concerning the formulation and, not least, the implementation of monetary policy. One fruit of the Central Bank's work in this area was a comprehensive report published in mid-1997 on the Economic and Monetary Union.

The Central Bank of Iceland changed its monetary instruments

In March 1998 the Central Bank of Iceland made an extensive reform of its monetary instruments. The guiding principle was to bring these instruments into line with those already decided for the ECB, even though it had not yet become functional. Consequently, since this time the Central Bank of Iceland has employed working procedures which in principle are analogous to those used by the ECB. The main difference is in the repurchase agreement auction format. Hitherto, the Central Bank of Iceland has auctioned unlimited amounts at a fixed rate of interest. Initially the ECB decided both the interest rate and total amount of its repo auctions at any time. The result was that the ECB only accepted a fraction of the bids made for its repos. This arrangement was abandoned and more recently the ECB has invited bids for a specific amount, but not at any predetermined rate of interest. Amounts are decided on the basis of the ECB's assessment of the credit institutions' liquidity requirement and the money market interest rates which it aims to achieve. One reason for the ECB's choice of this format is that the various EMU central banks operated different arrangements for liquidity facilities before the ECB was established, and different viewpoints needed to be reconciled.

Regarding other aspects of central bank activities and their effect in Iceland, it should perhaps first be pointed out that the Central Bank of Iceland began increasing the transparency of its activities and actions long ago. Among other things, this is reflected in the Bank's efforts to explain more clearly its policy and assessment of the economic and monetary situation and outlook. One step in this direction was taken towards the end of 1999 with a thorough review of the Bank's publishing activities. It ceased publication of *Monthly Statistics*, which had appeared since 1974, and launched the quarterly *Monetary Bulletin* which provides a much better forum than earlier publications for presenting in-depth explanations of the Bank's assessment of the economic and monetary situation and outlook, its measures in domestic markets and its policies. Furthermore, the new bulletin created an opportunity to present other material which directly or indirectly concerns the Bank's policy. It was also decided that the bank's quarterly inflation forecast would be published in *Monetary Bulletin*. Thus *Monetary Bulletin* can be described as the main platform today for the Central Bank's accountability towards the Government and general public.

New Central Bank Act

The most important milestone in the changes affecting the Central Bank, however, was reached this year with new legislation passed by parliament. A committee appointed by the Prime Minister at the end of last year submitted its proposals for a draft Central Bank Act in March. The bill was presented to parliament in the beginning of April and such a broad consensus was reached that it was passed with the unanimous votes of all 56 members of parliament who attended the final vote. The new Central Bank Act is closely modelled on the legislative framework that had been created for central banks in other countries in recent years, including the EMU. A simple target was set for the Central Bank of Iceland, i.e. to promote price stability, it was granted full independence to use its instruments, its financial independence was ensured and legal requirements were made for transparency and accountability, along with other points. I think it is fair to say that the new Central Bank Act generated interest internationally, not least for the speed at which the legal review was made and the broad consensus achieved on the reforms.

The Central Bank Act authorises the declaration of a numerical target for inflation, subject to the Prime Minister's approval. This provision incorporates into law the policy introduced on March 27 this year when the monetary framework was changed and the flexible fixed exchange rate was replaced with an inflation target and floating exchange rate. Despite very detailed discussion of the framework changes and the fundamental principles of the new policy, the Bank has often noticed widespread misunderstandings. I shall therefore outline the broad principles of monetary policy.

Inflation is a monetary phenomenon

The Central Bank was assigned a specific inflation target in the joint declaration which it issued, with the Government, on March 27. This stipulated that the Bank should aim for a rate of inflation as close as possible to 2½%. Tolerance limits were also set, 1½% higher than the inflation target and 1½% lower. The inflation target was defined as the twelve-month rise in the CPI. If inflation exceeded the tolerance limits, the Bank would be obliged to bring it back within them as quickly 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 target. When the target was set, inflation was running relatively high in Iceland. Bearing that in mind, the upper tolerance limit was set for 6% this year, 4½% in 2002 and then 4% from the year 2003 onwards.

Upheavals in the foreign exchange market in the spring and a sharp depreciation of the króna caused a substantial rise in inflation, which exceeded the upper tolerance limit in June. The Central Bank submitted a detailed report to the Government on June 20. Other aspects of the joint declaration included a provision that, notwithstanding the abolition of the exchange rate target band, the Central Bank would intervene in the interbank market in 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. At the same time, the Central Bank undertook to produce a quarterly inflation forecast projecting two years into the future.

It should be remembered that one of the main reasons for the simplification of central bank targets in recent years, and for assigning them the main objective of price stability, is that inflation is primarily a monetary phenomenon and the long-term impact of monetary policy is above all on prices. Its impact on economic growth and employment is therefore generally only temporary. 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 is based.

From the above it is clear that the Central Bank's main task is to achieve the inflation target, and this is what it aims to do. There have been vocal calls recently for the Central Bank to ease its monetary stance in order to soften or even prevent a looming economic contraction. The growth outlook has an impact on the output gap, i.e. the deviation in demand from a level which is consistent with balanced supply and demand for domestic goods and factors of production. The output gap is subsequently one of the factors that play a key role in the inflation cycle. All things being equal, the growth outlook thus exerts an influence on monetary policy, namely the worse the outlook, the lower the interest rate, and the contrary. For as long as inflation remains at its present high level, however, it is unavoidable to allow the output gap to shrink sufficiently and the Central Bank cannot apply its instruments at this stage to prevent that happening.

High interest rates are counter-inflationary

The Central Bank has held the view that, until clear signs emerge that its August inflation forecast will hold good, it is still not safe to lower interest rates. Impulsive action could entail a risk that inflation will magnify even further, with very dire consequences for households, businesses and economic growth conditions. Claims have also been heard that Iceland's high interest rates are inflationary rather than counter-inflationary. The Central Bank does not agree with this view, which cannot be supported with economic theories, studies or research. On the contrary, there is every indication that interest rates have a similar effect in Iceland to that elsewhere. The Icelandic economy was showing signs of strong overheating which apparently peaked last year. It is beyond doubt that the tight monetary stance made a major contribution towards cooling the economy. And such a winding down was necessary, too, since great macroeconomic imbalances had emerged, reflected most clearly in an unacceptable current account deficit and inflationary pressures. It is therefore inevitable that the output gap will narrow in order to bring down inflation, and that national income will drop even further in order to achieve a significant reduction in the current account deficit, which is far beyond a sustainable long-term level.

High interest rates can be painful, not least for the households and businesses that have been imprudent in their consumption and investments recently and have relied too heavily on the facilities of credit institutions. It is out of the question for the Central Bank to base its interest rate policy on the actions of the least prudent members of the community. This can only be based on provisions made in laws and the joint declaration by the Government and the Central Bank this March, i.e. to promote price stability. This is the guiding aim of central bank activities in industrial countries around the world, because it creates a climate for economic growth and greater well-being for citizens. In a world of free capital movements and greatly enhanced access to credit compared with earlier times, businesses and households, and credit institutions too, must find their bearings for themselves.

Understandably, many people complain about high interest rates, but the lively debates in recent weeks have often revealed excessive faith in the effect that an interest rate cut would have on economic developments. A slowdown in economic activity is not solely caused by interest rates. Other factors that deserve to be mentioned are the contractionary impact of fishing quota cuts, the downturn in the IT sector which is closely linked to global trends, and fluctuations in power-intensive development projects which are unaffected by domestic interest rates. Cutting interest rates now would have a limited immediate effect on the supply side of the economy, while high interest rates act with full force on the demand side where they serve to reduce inflation and domestic demand, which will contribute to improved macroeconomic balance and low inflation.

Iceland's currency options

I have outlined various aspects of the Central Bank's monetary policy. As I mentioned, Iceland has not taken part in European currency cooperation. Various currency framework options that Iceland ought to consider are often named in public discussions. A detailed account of most of them was given in the Central Bank's 1997 report on the EMU. It is frequently said that Iceland ought to adopt the Euro as its currency, either unilaterally or through associate membership of the EMU. I strongly warn against simplifying the options available to us in this respect. Even if associate membership were being offered, which does not seem likely, it seems fair to assume that any country which was interested in it would need to fulfil the Maastricht Treaty requirements for EMU membership. These include a rate of inflation no higher than 1½% above that in the three EU countries where it is lowest, a one-year record of average nominal interest rates on long-term bonds no more than 2% higher than in the three EU countries where inflation is lowest, and membership of the ERM for at least two years without devaluing the currency and without exceeding the deviation band. Iceland will obviously not be fulfilling these conditions in the immediate future. Some form of EMU membership in the future would therefore not release Iceland from the obligation to bring inflation down to a similar level to that among its trading partner countries. It may be added that even if Iceland fulfilled all these conditions, it is extremely unlikely that it would be able to negotiate, in the foreseeable future, associate membership of the EMU or some kind of other bilateral currency cooperation with it. All the signs point in the opposite direction, whatever the phrasing of individual articles in the Treaty of Rome and Maastricht Treaty might suggest. Furthermore, it should be pointed out that twelve Eastern European countries are waiting to be admitted to the European Union and, later, the EMU. The ECB and Community leadership have firmly underlined that these nations should fulfil all the conditions for participation in EMU. Thus the EU is highly unlikely to agree to set any precedent which these nations could take advantage of as a short-cut into the EMU.

Iceland has chosen to remain outside the EU and has not declared an interest in membership. If Iceland were to show an interest in adopting the Euro as its currency, the most obvious course would be to join the EU with all the advantages and obligations that this entails, including membership of the EMU. Such a decision, however, depends on more factors than just the national currency, and this process would take a good many years. Of course, this is a highly political question and therefore outside the scope of this address. We need to continue to find our bearings in the global community as a nation with its own currency, which in an environment of free capital movements calls for very disciplined economic policy implementation.

Ladies and Gentlemen:

Representatives of all EU countries were involved in formulating and developing the Economic and Monetary Union. They created a monetary framework within the EMU which they regarded as serving the Community's citizens best. Although Iceland stands outside the EMU, we have incorporated into our monetary policy implementation much of what the EU countries agreed that best served their interests. I am convinced that we will benefit from this.