Birgir Ísleifur Gunnarsson: Iceland in a global setting

Keynote speech by Mr Birgir Ísleifur Gunnarsson, Chairman of the Board of Governors of the Central Bank of Iceland, at the Euromoney conference on the Nordic Financial Markets and Investment Opportunities, Stockholm, 13 September 2002.

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Mr. Chairman, ladies and gentlemen.

It is a pleasure to participate in this ambitious conference on the Nordic Financial Markets and Investment Opportunities. I will in my remarks today mainly focus on aspects relating to Iceland.

Size separates Iceland from the other Nordic Countries, Denmark, Finland, Norway and Sweden. Other factors separate the Nordic Countries as well. Finland is a member of the European Union and the Economic and Monetary Union, EMU, as well. Denmark and Sweden are members of the European Union but are outside the EMU. Norway and Iceland are outside the European Union but maintain very close ties to it, particularly through the European Economic Area Agreement. That agreement makes Norway and Iceland a part of the single market of the European Union, which entails among other things that they are obliged to maintain financial market legislation, which fully conforms to that of the European Union.

The Nordic Countries have different monetary regimes. Finland is a member of the EMU, Denmark is linked to the EMU through an ERM II agreement entailing that the Danish krona is very closely tied to the euro. Sweden, Norway and Iceland have chosen an inflation-targeting regime as their monetary framework (Iceland in March 2001). Thus, price stability is the main objective of monetary policy in all of these countries and has in fact become the recognized single target for monetary policy in numerous countries. The reason for this emphasis on price stability is that it creates the best conditions for balanced growth and increased welfare.

The Icelandic financial market has developed very rapidly over the last ten to fifteen years. It is a small market by definition, but has nevertheless the same institutional set-up as larger industrial countries. Aside from the Central Bank, these include commercial banks, savings banks, securities companies, various investment funds, insurance companies, large and important pension funds and last but not least a stock exchange - linked with the other Nordic exchanges - where the shares of 60 to 70 Icelandic companies are listed and traded on regular basis. Supervision of the activities of all of these institutions is in the hands of a unified financial supervisory authority that has broadly the same legal powers and follows the same methods and standards as supervisory agencies in other European countries.

Important rationalisation has taken place in the Icelandic financial system. Until a few years ago, two of the main commercial banks were fully government owned and so were a host of so-called investment credit funds. The funds were unified in a single institution, which was subsequently privatised. The Government has also reduced its stake in the commercial banks over the most recent years and intends to have them largely or fully privatised by the end of the current electoral term next year. The privatisation process creates opportunities for continued rationalisation in the financial system creating ample opportunities in the period ahead, including closer ties with foreign financial institutions.

It is tempting to put recent economic developments in Iceland into the context of developments in some of the other Nordic Countries about a decade ago. Liberalisation of the Icelandic financial markets was more or less completed in the mid-1990s when the last restrictions on the movement of capital between Iceland and other countries were removed. Our liberalisation came a few years later than in the other Nordic Countries. You will recall that in some of the other Nordic Countries, liberalisation was followed by a boom period in the economy, partly or largely fuelled by a rapid growth of credit and in some cases large fiscal deficits. At the same time, these countries were pursuing a fixed exchange rate policy vis-a-vis the ECU. Developments in the domestic economies were such that the fixed exchange rate policy was gradually undermined, the rapid credit growth of banks resulted in weakening loan portfolios when asset prices fell, the exchange rate fixety gave way to floating, the currencies depreciated and inflation rose. The current account of the balance of payments also deteriorated.

Developments in Iceland from the latter half of 1990s until the present time resemble in many ways the experience of some of the other Nordic Countries a decade earlier but differ also in important respects. Soon after liberalisation, domestic demand picked up, fuelled by rapidly rising credit in the wake of intensified competition in the financial sector and a sharp increase in credit availability. At that time, Iceland was pursuing a fixed exchange rate policy but not as rigidly fixed as the other Nordic Countries had done a decade earlier. The expansion in the economy at the end of last decade led to a very rapid rise in the current account deficit, climaxing in year 2000. Through the effects of a tightening monetary policy, the exchange rate of the króna gradually appreciated. In the spring of the year 2000, expectations in the market shifted for a variety of reasons, one of them being concerns about the current account deficit. Subsequently the króna began to depreciate and continued to do so more or less uninterrupted but on the whole in an orderly fashion over a period of a year and a half until the end of November last year. By that time, it had fallen by about a third against other currencies. This large depreciation is not without precedent in other countries. In that respect, I might mention, since we are in Stockholm and since I have drawn some parallel with the other Nordic Countries, that the Swedish krona fell in broadly similar proportions over a period of time after the exchange rate was floated in late 1992. The depreciation of the Icelandic króna fed into domestic prices and inflation picked up significantly.

Late last year, the exchange rate had clearly overshot sharply on the downside. Then expectations turned around again. It was clear, among other things, that the economy was cooling down and that the current account deficit was shrinking fast. Optimism also arose once prospects improved that the inflation spike, which followed the exchange rate depreciation, would subside quickly again. The króna began to appreciate and has by now regained an important part of its earlier value.

Inflation has subsided sharply again this year and expectations are that the inflation target of 2½ percent will be achieved before the end of the year. The large current account deficit recorded in the year 2000 also began to shrink rapidly, it fell by more than half in the year 2001 and the outlook is for approximate balance this year.

These developments demonstrate the resilience and adaptability of the Icelandic economy; moving from a very large current account deficit to virtual balance in the course of two years and reducing inflation from bordering on a two-digit rate to 2½ percent within one year.

Although developments in Iceland showed many of the same characteristics as those in some of the other Nordic Countries during the post-liberalisation rapid expansion, such as credit expansion, current account deficit, exchange rate depreciation and so on, Iceland escaped the difficulties suffered by banking systems in some of the other countries.

Icelandic bank credit grew very rapidly in the late 1990’s and into the year 2000 and a sizable portion of the credit expansion was financed with credit from abroad. The capital adequacy ratios of banks fell for a while but nevertheless remained comfortably above the minimum required and internationally recognised levels. The year 2001 also turned out to be quite favourable for the banks, a development which continued by and large into the current year. Consequently, the capital position of the banks has improved and all the major banking institutions have relatively strong capital adequacy ratios at present. Loan losses have increased, as was to be expected in the wake of the credit expansion, but nowhere on the scale experienced in some of the other Nordic Countries a decade ago and very much less than they did during the downturn in the Icelandic economy around and after 1990. The conclusion to be drawn is, therefore, that the Icelandic banking system weathered the relatively turbulent post-liberalization boom period of 2000 and 2001 pretty well and is well poised to meet new challenges, including continued rationalisation and intensified competition from foreign banking institutions.

In the most recent decades, the Icelandic economy has also seen structural shifts. The importance of fisheries as a generator of foreign exchange revenue has diminished in relative terms - to less than a half of the total - while the importance of other sectors has risen, such as manufacturing industry, information technology and tourism. In these developments, Iceland is among other things drawing benefits from globalisation to strengthen the foundations of the economy. Foreign direct investment regulations are liberal with the exception that such investment is not permitted in the fishing sector. Foreign direct investment is most noticeable in power intensive industry, such as the production of aluminium, which is based on Iceland’s abundance of untapped renewable energy resources. Recent changes in corporate taxation in Iceland, lowering corporate taxes to among the lowest to be found, serve to attract foreign business to Iceland and encourage Icelandic companies with international operations to favour Iceland as the base of their operations.

Direct investment by Icelandic companies abroad has risen rapidly in recent years and in a variety of areas, such as fisheries and fish processing, pharmaceuticals, retail commerce and financial services. These developments also benefit the Icelandic economy in the long run as they integrate Iceland further into the global economy, allow Iceland to draw more easily on the experience of others and bring in dividends. Reflective of this development is the fact that Icelandic banks have begun to grant credit to borrowers in other countries on a measurable scale, particularly in areas where they have a competitive advantage in analysing the soundness of the prospective borrowers.

The title of my presentation is Iceland in a Global Setting. What I have briefly described is a country that has followed the path of many countries, including the Nordic Countries, in liberalising its economy, both internally and externally. This has exposed the economy to market forces and competition from abroad and a monetary regime bent on securing a low rate of inflation was chosen. Iceland is, as mentioned, not a member of the European Union and membership is not on the agenda of the present Government. Iceland operates its own small currency on the margins of the US dollar and the euro. These facts place firm requirements on economic policy while at the same time offering Iceland to reap important benefits from globalisation. This is indeed born out by developments over the last few years that were years of rapid growth of GDP and years which tested the ability of economic policy makers to steer the economy in an environment of liberalised markets and capital movements. More generally, the lesson to be drawn from our experience is that countries only stand to gain from full participation in the global economy. Aside from subjecting the domestic economy to competition from abroad, it disciplines economic policymaking. The market is a strict master and serves painful punishment for mistakes or ill-thought initiatives.