Ingimundur Friðriksson: The Central Bank of Iceland and monetary policy

Speech by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, at a civic club meeting in Reykjavík, 12 February 2003.

*   *   *

In recent years substantial changes have been taking place in central banking in many parts of the world. The main reason is the gradual acceptance of the view that it is natural to anchor central bank monetary policy to a single main objective. Simplified objectives were therefore set for central banks and they were granted greater independence to apply their monetary policy instruments, while more stringent demands were made regarding transparency of monetary policy and central banking activities, and accountability to the government and general public. As a rule, simplification of central bank objectives involved defining a single main objective, i.e. to promote price stability. Central banks were often also assigned a second objective, namely to promote the security of financial systems, or financial stability.

Price stability was made the main objective of monetary policy because inflation is above all a monetary phenomenon. There is little point in setting an objective for monetary policy which it cannot attain. Applying monetary policy in order to achieve price stability also contributes to economic stability. This, in turn, provides a basis for the economy to be able to achieve lasting growth and make the most efficient use of its scarce resources.

The year 2001 was an eventful one in the history of the Central Bank of Iceland. In March that year the government and the Central Bank issued a joint declaration abandoning the fixed exchange rate policy and adopting inflation targeting as the mainstay of monetary policy in its place. A target was set for the Central Bank's monetary policy to keep inflation as close as possible to 2½%, to be attained before the end of 2003. One consequence was that the exchange rate of the króna was floated. Just under two months later, parliament unanimously passed a new Central Bank Act which entailed extensive changes from the earlier legislation. Inflation targeting has established itself in many countries in recent years and has formed the backbone of monetary policy in countries such as the UK, Sweden, Norway and New Zealand, with good results.

The new act took account of central bank legislation in other countries and one of its aims is to consolidate the new inflation targeting policy. The most important change from the legislation it replaced was to set a single principal objective for the Central Bank, i.e. to contribute towards price stability. It was granted independence to apply its instruments in order to attain this objective. Furthermore, the Bank was assigned the task of maintaining Iceland's foreign exchange reserve and contributing to an efficient and reliable financial system, i.e. financial stability. The act also stipulated that the treasury may not borrow from the Central Bank. Specific requirements were made concerning accountability and transparency. For example, the Bank is now obliged to present public explanations every quarter of its monetary policy and monetary, exchange rate and currency developments, and its measures in these areas.

As I said earlier, the main objective of Central Bank monetary policy is to keep inflation as close as possible to 2½%. The Central Bank has only a single instrument for achieving this objective: interest rates. The crucial interest rate here is that used in the Central Bank's repurchase transactions with credit institutions, sometimes called the policy interest rate. Such transactions effectively represent the Bank's liquidity facility for these institutions. The commercial and savings banks then decide their own rates of interest with reference to the Central Bank's policy rate and short-term interest rates invariably alter in pace with the Central Bank rate. Other things being equal, changes in the Central Bank interest rate also affect long-term interest rates, but other factors have an impact as well. Their responses to the Central Bank's interest rate changes are therefore not always foreseeable and tend to take place with some lag.

Inflation forecasting plays a crucial role in the Central Bank's current activities. It produces four forecasts a year and publishes them in its quarterly Monetary Bulletin. The inflation forecast is projected just over two years into the future, on a quarter-by-quarter basis. As in other countries, Central Bank interest rate changes take a long while to have an impact on the economy. The inflation forecast therefore needs to be forward-looking and based on the best available methodologies. Besides inflation forecasting, the Central Bank publishes a quarterly assessment of the economic and monetary situation and prospects, including a national economic forecast, and their probable impact on price developments. If inflation is heading beyond the Bank's target on a longer-term scenario, the Bank raises its policy interest rate, but cuts it if inflation is heading below the target.

In preparing its inflation forecasts and regular assessments of the economic situation and prospects, the Central Bank examines a wide range of indicators. These are both statistical data and information obtained from interviews with representatives of industry, organisations with vested interests, credit institutions and others. The Bank publishes the bulk of its statistical indicators and data on its website.

Central Bank decisions are made after in-depth examinations of indicators about economic developments, its assessment of the situation and outlook, the assumptions behind the inflation forecast and the inflation forecast itself. Under the Central Bank Act, the Bank's Board of Governors have set internal rules on the preparations of, arguments for and presentation of its monetary policy decisions. These rules were formally set in the beginning of 2002 and published in the quarterly Monetary Bulletin.

Having said this, it is tempting to try to assess the success of monetary policy implementation after the framework was changed and the new Central Bank Act went into effect in spring 2001. There was already some inflation in spring 2001 and a rapid slide in the exchange rate of the króna until the end of November 2001 caused inflation to increase substantially, from around 4% when inflation targeting was adopted to 9½% in the beginning of 2002. Inflation surged following heavy demand pressure in the economy which was driven by large-scale credit expansion and resulted in an enormous current account deficit, peaking in 2000 at 10% of GDP. For most of the period of overheating the Central Bank did not follow a direct inflation target and the backbone of monetary policy was a fixed exchange rate, with a fluctuation band, i.e. a soft exchange rate peg. Nonetheless, the Central Bank sought to counter inflationary pressures as soon as 1999 and began raising interest rates, which caused the króna to strengthen until spring 2000. Expectations changed then, partly under the impact of the wide current account deficit, and the currency inflow diminished. A downward exchange rate trend then began.

The Bank raised its policy interest rate in phases until the end of 2000 when it reached 11.4%, where it remained until spring 2001 when a minor cut was made. The interest rate remained unchanged until late 2001 when the Bank felt it could discern clear signs that inflation was beginning to come down again. By then, the exchange rate of the króna had fallen by almost one-third from its highest point in spring 2000. By then the Central Bank had repeatedly stated that the exchange rate of the króna had become much weaker than warranted by economic fundamentals.

The impact of the tight monetary stance was increasingly felt as the year 2001 wore on. The sharp turnaround in the exchange rate at the end of November that year and the agreement between the Federation of Icelandic Labour and Confederation of Employees in December 2001, postponing an inflation-triggered review of wage agreements, eased the uncertainty and changed expectations. Both these events led to a rapid drop in inflation in 2002, and by last November the Central Bank's inflation target was attained, one year before this was envisaged in the joint declaration by the government and the Central Bank from March 2001.

When it became clear that inflation was on a significant downward path, the Central Bank gradually began to lower its interest rates. It also announced that it aimed to cut them in more and smaller steps rather than fewer and larger ones, not least with the idea of maintaining calm in the forex market. Since April last year the Central Bank has lowered its interest rates eleven times by a total of 4.8 percentage points, including the cut announced on February 10. The Central Bank's rate for its repo agreements with credit institutions is now lower than it has ever been since the current arrangements for such transactions were introduced early in 1998, when it was 7.2%, and in fact is at its lowest level since 1994. The policy rate is currently 5.3%. The exchange rate of the króna was fairly stable from last spring and until the winter, then strengthened again towards the end of the year and in the beginning of this year, to reach its highest point for two years. Undoubtedly the expected power-intensive industrial project in east Iceland is a contributing factor.

The new monetary policy framework was introduced in a fairly tough climate of a sliding exchange rate and mounting inflation. It is fair to say that the tight monetary stance is the main reason that inflation went back down so quickly. Experience has shown that the monetary policy passed its initial test with flying colours and no one should have any doubts now about the value of monetary policy in the Icelandic economy. It works in Iceland, just as it does everywhere else.

On February 10 the Central Bank published its quarterly *Monetary Bulletin*. As usual, this contains a new inflation forecast along with the Bank's latest national economic forecast and a new assessment of economic and monetary developments and prospects. The bulletin also contains an evaluation of the impact of the proposed power-intensive industry and hydropower development projects in east Iceland, which were incorporated into the inflation forecast and national economic forecast.

The forecast assumes that inflation will be below the Bank's target over the next two years. On the basis of this and the new economic forecast, the Governors announced a cut of 0.5 percentage points in the Bank's policy rate last Monday. One of the standard assumptions behind the forecast is an unchanged exchange rate from the forecasting day, and it should be borne in mind that it did not take into account the interest rate cut which was announced on February 10. The impact of the cut will be a marginally higher rate of inflation than was assumed in the forecast.

It should also be mentioned that *Monetary Bulletin* contains an announcement about pending changes to rules on required reserves aimed at harmonising the operating conditions of Icelandic credit institutions with those of comparable institutions in EMU. To be implemented in phases this year, the new rules involve a considerable reduction in the credit institutions' required reserve from the present levels, thus entailing some easing of the monetary stance.

Broadly speaking, the Central Bank's assessment and forecasts entail a fairly moderate rate of economic growth this year, unemployment of around 3½% this year (excluding the effects of new government measures in this area) but falling somewhat next year, a minor current account deficit this year and next year – in particular caused by imports connected with the construction programmes in east Iceland – and a very moderate rate of inflation. Thus it can be said that the outlook is for good macroeconomic balance.

As I mentioned earlier, *Monetary Bulletin* includes an in-depth assessment by the Bank of the proposed power-intensive industrial projects in east Iceland and conceivable economic policy responses to them. In this context it is important to remember that relatively little development will take place in east Iceland this year and for most of next year. The effect will not begin to be felt to any extent until well into next year and the bulk of construction work will take place in 2005 and 2006. The main conclusion of the Bank's analysis is that even though this will be the largest construction programme in the history of Iceland, it should be able to go through without disrupting the economy. However, this calls for cautious economic policy implementation. The Central Bank's analysis shows that with a somewhat stronger exchange rate and higher interest rates than would otherwise have prevailed, and a tighter fiscal stance than would have been needed, inflation will remain inside the tolerance limits of the target, i.e. below 4%, and that this will prevent the economic instability that the construction programme in east Iceland would otherwise have caused. Exchange rate developments and the fiscal input will be major factors in determining how much interest rates will need to rise. However, neither an exchange rate adjustment nor fiscal measures can entirely replace monetary measures, since the change in exchange rate partly reflects expectations of a rise in Central Bank interest rates, beside which the scope of the east Iceland construction programme will simply be too great to be countered solely by cutting back public sector activity.

Without sensible economic policy implementation, however, the construction programme would be likely to lead to overheating of the economy, high inflation and instability. There is no the scope to discuss the Bank's analysis further here, however, so I shall merely refer to the coverage in the latest *Monetary Bulletin*.

In recent public discussions it has repeatedly been claimed that the exchange rate of the króna is too high and the Central Bank needs to take measures to bring it back down, such as a large-scale cut in interest rates, which are said to be much higher in Iceland than elsewhere. The fact of the matter is that the interest rate differential between Iceland and its main trading partner countries has narrowed significantly recently. The short-term interest rate differential has not been less since 1996. The Central Bank of Iceland's policy rate is now lower than, for example, those of the Norwegian Central Bank and the New Zealand Reserve Bank, both of which also apply inflation targeting. The same applies to the policy rate in real terms, calculated relative to these banks' respective inflation targets. In fact, in real terms the Central Bank of Iceland's policy rate is at its lowest point since 1996.

In this context it is also important to point out that after the change in the monetary framework in March 2001, i.e. after an inflation target was set for monetary policy and the króna was floated, the Central Bank has no specific objective as regards defending the exchange rate of the króna, which is determined on a day-to-day basis by supply and demand in the domestic forex market. Various factors affect currency flows, such as interest rates and the interest rate differential with abroad, the merchandise and services balance and, last but not least, expectations about the future.

It may also be noted that, since the autumn, the Central Bank has regularly purchased foreign currency in the domestic interbank market. The purpose of such purchases is to boost the Bank's foreign reserve, which was significantly depleted during its efforts to control the slide in the króna in 2000 and 2001, and not to influence the exchange rate, although undoubtedly they do so to some extent. The Bank's experience shows that direct intervention in the forex market with the aim of influencing the exchange rate of the króna only has a short-term effect at best. Regular foreign exchange purchases were stepped up in January and again in February. Now, the Bank purchases 1½ million US dollars daily and has purchased the equivalent of 11 b.kr. since the autumn.

In the Central Bank's view, various factors may have caused the króna to strengthen in recent weeks, not least expectations about the east Iceland construction projects, a possible underestimation of the degree of slack in the economy at the moment, and increased fishing quotas. In assessing the exchange rate it is important to point out that in real terms the exchange rate is not much higher at present than its average over the past ten years. Thus there is no possible way to claim that the current exchange rate is blatantly out of step with what is appropriate for the economy or is far from the real equilibrium exchange rate.

It has also been claimed that there is a significant risk of deflation in Iceland. The Central Bank considers the likelihood of this to be negligible. In fact, the talk of deflation can largely be expected to reflect international discussion of the same issue, with claims from various quarters that there is a risk of deflation in Germany and the USA in the same way that has happened in Japan. Nothing suggests that deflation is looming in Iceland – wage costs have risen, growth in money supply is robust, inflation expectations in the market are around 2% or above, and one of the largest construction programmes in Icelandic history is on the horizon. It may be added that, up until now, Iceland has never had any problems in kindling inflation.

In light of all the above, the Central Bank does not believe that there are grounds for a large cut in interest rates in order to bring down the exchange rate of the króna or dispel the risk of deflation, which is virtually nil anyway. Such action would probably pave the way for subsequent overheating of the economy and inflation. The Central Bank will continue to base its interest rate decisions on its mandatory role of contributing towards price stability and on the joint declaration of the government and the Bank from March 2001 which specifies the inflation target. Through steadfast monetary policy which ensures price stability, monetary measures will contribute towards promoting a stable economic environment which is the foundation for the economy's growth capacity in the long run.

On the basis of the new inflation forecast and national economic forecast, the Central Bank announced a cut of 0.5 percentage points in the policy interest rate on February 10. The Consumer Price Index for the beginning of February was published this morning and the change in it turned out to be fully consistent with the Bank's latest inflation forecast. Developments in the next few weeks and the prospects ahead will determine the next step as regards interest rates. Opposing trends are at work there and at present it is impossible to state in which direction or when the next step will be taken. It also needs to be underlined that if the current outlook turns out to be correct, the proposed construction programme in east Iceland will gradually begin to influence the formulation of monetary policy. To conclude, I would like to reiterate that monetary decisions by the Governors of the Central Bank of Iceland are made after extremely careful consideration of a large number of indicators.