Mr. Gunnarsson reports on some aspects of economic conditions and current prospects in Iceland Address by the Governor of the Central Bank of Iceland, Mr. Birgir Isl. Gunnarsson, at the Bank's Annual Meeting on 31/3/98.

On behalf of the Board of Governors of the Central Bank I welcome you to this 37th Annual Meeting of the Bank. The Bank's Annual Accounts for 1997 have today been ratified by the Minister of Commerce, and the Bank's Annual Report has been published. The Report gives an overview of the Bank's operations and a detailed description of economic and monetary developments in the past year, as well as of the Bank's monetary policy objectives and measures. I will discuss some aspects of economic conditions and current prospects, mainly those that are most closely linked to the Central Bank's areas of responsibility.

Economic Growth

GDP grew sharply in 1997 for the second year in a row. It is estimated that growth was 5 percent, compared with 5.5 percent in 1996. Economic growth in Iceland during these two years has been far higher than in other industrial countries. In the European Union growth was 2.6 percent and in the United States 3.8 percent; in Japan, which has faced adversity in recent times, growth was only 1 percent. The British economy has strengthened in recent years and growth is estimated to have been 3 percent in 1997. The rapid growth of the domestic economy inevitably raises the question of whether this is consistent in the long run with the economic stability that has been achieved in recent years. The growing current account deficit clearly preaches caution and underscores the need for sufficiently tight monetary and fiscal conditions.

Growth in 1997 was primarily driven by growing private consumption and fixed investment. Private consumption rose by 6 percent and fixed investment by 9.9 percent. Over the last two years fixed investment has increased sharply following many years of contraction. Investment in power-intensive industry has played an important role, as has investment in commercial buildings. Housing investment has also begun to recover during the last two years but not sufficiently to offset the decline in the previous year.

Current Account Deficit

The current account deficit turned out smaller in 1997 than had been expected, or just in excess of 8 billion kronur. Merchandise imports grew by 5.9 percent in volume terms, with consumer goods accounting for three-fifths of the increase and investment goods for less than a third. Here it needs to be borne in mind that it may have been mere coincidence whether imports for power-intensive industrial projects were recorded in 1997 or 1998. More appear to have been recorded in 1998 than expected. Merchandise exports grew by less than 2 percent in volume terms, which is not a particularly good performance. The growth of exports is in fact too slow in relation to, for example, the expansion of world trade. Thus, it can be said that slow export growth is as much the cause of the current account deficit as the expansion of domestic demand.

Business Profitability and the Labour Market

The external conditions of the economy in 1997 were largely unchanged from 1996, and were on the whole favourable. Business profitability seems to have been fairly good, although not as favourable as in 1996, because of the wage increases at the beginning of the year and large depreciation and interest charges related to the high levels of investment in recent years, especially in the fisheries. The labour market situation improved further and unemployment declined to 3.9 percent on average, having come down from a peak of 5 percent in 1995. Real wages grew by 5.7 percent in the course of 1997, and were at year-end at their highest level since 1989.

Prices

Inflation remained subdued in 1997, or 2.2 percent in the course of the year, and 1.8 percent on average between 1996 and 1997. The Central Bank had, in the wake of the wage settlements, forecast somewhat higher inflation but wage increases did not translate into price increases to the extent shown by past experience. Productivity growth was higher than expected and the rise in import prices lower. In addition, the Central Bank's measures restrained price increases, as I will discuss in greater detail shortly. In January, the Bank forecast that inflation would average 2.6 percent between 1997 and 1998, and 2.3 percent in the course of the year. It seems clear that inflation during the first quarter of this year has been lower than expected in January.

Government Finances

In 1997, the Treasury recorded a welcome surplus of 1.3 billion kronur on a cash basis despite tax cuts, a rise in the wage bill and special interest payments associated with government bond redemptions. In order to compare the outcome with the budget it is necessary to exclude the special interest payments of 3.5 billion kronur. Thus adjusted, the Treasury's surplus was 4.7 billion kronur. A Treasury surplus had not been recorded since 1984. On an accrual basis, which includes accrued interest and pension liabilities, the Treasury's finances appear to have been close to balance in 1997. The Treasury repaid debt during the year. Amortization of foreign debt exceeded new borrowing by 6.5 billion kronur, or the equivalent of 5 percent of the Treasury's foreign debt; this marked the first time since 1986 that amortization of foreign debt exceeded new borrowing. Domestically, new borrowing exceeded amortization by 3.4 billion kronur.

While this turnaround in the Treasury's finances is certainly to be welcomed, it is, nonetheless, a somewhat mixed blessing. It is a matter of concern that the budgeted improvement in the Treasury's finances in 1998 is less than warranted by the automatic stabilizers alone and that, all other things equal, the degree of fiscal restraint on domestic demand in 1998 will be less than last year. In preparations for the 1999 budget it is therefore of paramount importance, in light of economic conditions, to aim for a substantial Treasury surplus. The same considerations, of course, apply to the implementation of the 1998 budget, and any excess revenue should be used to improve the financial balance rather then end up as extra spending. I say this because there are limits on what monetary policy can accomplish to restrain domestic demand in the current circumstances.

Local government finances deteriorated somewhat in 1997. The combined revenue deficit of the 14 largest municipalities was 2.9 billion kronur. It is estimated that local government debt increased from 36 billion kronur to 42 billion kronur in 1997. General government debt in relation to GDP declined from 56 percent in 1996 to 52.7 percent in 1997, which, in light of the Maastricht limit on government debt of 60 percent of GDP, is a fairly good debt position.

Monetary Developments

The Central Bank's principal target remains price stability. The Bank's monetary instruments primarily influence inflation in the long run, and it is generally accepted that price stability is an important precondition for economic growth and improved living standards. Domestically there is a good consensus about this goal, as is the case in most countries where central banks pursue the same or a similar objective.

In an open economy such as the Icelandic one a stable exchange rate is necessary for favourable price developments. A stable exchange rate has, therefore, been an intermediate target for monetary policy. The Central Bank implements monetary policy mainly by setting its own interest rates and by intervening on the money market. In the short run the Bank can also influence the exchange rate through the purchase and sale of foreign currency.

Given the conditions that prevailed in 1997, there was clearly a danger of overheating which led the Central Bank to pursue a tight monetary policy. After the Bank had raised money market rates in the fall of 1996 the differential between domestic money market rates and those in main trading partner countries widened to 3 percentage points. This was a necessary response to the growing uncertainty about the outcome of the pending wage negotiations, and it led to an acceptable equilibrium for some time. However, some currency outflow was experienced during the first weeks of 1997 until the outline of the wage settlements began to emerge. The wage settlements eased fears of rising inflation and increased confidence in a stable exchange rate. The Central Bank, nevertheless, maintained unchanged interest rates, and considerable currency inflow took place through July. International reserves grew to a peak of 36.2 billion kronur at the end of July, up 5.2 billion kronur from the beginning of the year despite the repayment of some of the Treasury's foreign debt.

The Central Bank thought it desirable that the exchange rate of the krona should strengthen somewhat to lessen pressures on the domestic market and dampen inflation pressures. The Bank's measures undoubtedly contributed to lower inflation than expected.

Monetary developments changed course at the beginning of August. Currency outflow commenced anew and bond market yields began to rise. This change was the result of increased purchases of foreign securities by residents, a stop in the relending of foreign loans and an increase in general bank lending. The differential between domestic and foreign money market rates had also narrowed because of interest rate rises in some neighbouring countries. When it had become clear that this was not a temporary situation, the Central Bank responded by raising interest rates by 0.3 percent in mid-November. The interest rate had an immediate impact, the exchange rate of the krona strengthened and the currency outflow stopped. At the end of the year, the exchange rate index was 0.9 percent below the central rate of the fluctuation range after having strengthened on the whole by 1.4 percent in the course of the year. International reserves stood at 27.8 billion kronur at year-end, down 3 billion kronur from a year earlier. Reserves are now about 27 billion kronur. The Central Bank's short-term foreign liabilities were close to zero at year-end, where they in fact remain.

The Bond Market

Bond market reforms were continued in 1997. In 1996, the Central Bank decided to withdraw from the long-term market and reached custodian agreements with three securities firms following a bidding process. The Bank handed over to the firms a part of its securities portfolio and at the same time ceased to be a market maker in government bonds, government notes and housing bonds. The experience from these agreements is positive and they were renewed in March 1997. The new agreements were more extensive than the earlier ones, and in their wake two banks announced that they would engage in market making for certain classes of government securities in the same manner as the custodial firms. It is not unlikely that such custodial agreements will become unnecessary and that the Central Bank will no longer need to be involved in ensuring adequate market making in the long-term market. Both the Treasury and the State Housing Authority began to reorganize the classes of bonds they issue, with the effect of improving the price determination of government guaranteed bonds and raising turnover in the secondary market.

The Central Bank's Monetary Policy Instruments

In 1997, the Central Bank began preparing changes to its monetary policy instruments. The purpose was twofold: first, to level the playing field for domestic credit institutions with respect to their access to facilities at the Central Bank, and, second, to adjust the operating environment of domestic credit institutions to the environment prevailing in the European Economic Area.

These changes have been modelled on the instruments designed for the prospective European Central Bank, which will be established on July 1 and formally commence operations on January 1, 1999. Under the auspices of the European Monetary Institute, the precursor to the European Central Bank, work has proceeded on designing the monetary instruments of the bank. The Central Bank has followed this work to the extent possible. Some issues, such as concerning reserve requirements, will not be resolved until after the European Central Bank has been established. The Central Bank may therefore adjust its rules when the situation in Europe becomes clearer.

The first step in changing the Central Bank's instruments was taken on March 1 and covered the following. The liquidity requirement of deposit banks was abolished. Weekly auctions of 14-day repurchase agreements replaced the tap-sale of these agreements. All government guaranteed securities and the Central Bank's certificates of deposit qualify as collateral for repurchase agreements rather than only Treasury bills and certificates of deposit. The Central Bank will auction 14-day certificates of deposit when it feels the need to withdraw liquidity. The direct sale of 45-day certificates of deposit will cease, but 90-day certificates will continue to be sold. A new overnight facility for credit institutions subject to reserve requirements was established at the Central Bank. Collateral for overnight loans will be provided by government guaranteed securities held by the credit institutions.

The next step in these changes will take place on April 1 when new rules governing reserve requirements will take effect. The reserve base will be widened to include the foreign borrowing of credit institutions while the reserve requirement ratio will be lowered as the change is intended to be broadly neutral with respect to required deposits, thus making the change neutral from a monetary policy perspective. The reserve requirement ratio will be 4 percent on obligations under 1 year to maturity but 1.5 percent on obligations tied for longer than 1 year. Also, the reserve requirement will cover more institutions than before, and only institutions subject to reserve requirements will have access to facilities at the Central Bank. It will be possible to meet the reserve requirement more flexibly than has been the case. Indexation of required deposits will be abolished but the interest rate on them will initially be set on the basis of prevailing yields.

The last step in these changes will be taken on May 21 when the first calculations based on the new rules concerning reserve requirements will be done. At the same time, the so-called discount quota, which is a facility that the Central Bank has offered to deposit banks, will be abolished. The Bank will also close the foreign currency accounts of deposit banks it has held.

Since 1987 the Central Bank has targeted interest rates to achieve its monetary policy objective rather than targeting the money supply or base money. The access that deposit banks have to liquidity at the Central Bank is therefore flexible and at their own discretion, with the Bank's interest rates among the factors influencing the extent to which the draw on liquidity from the Central Bank. At the outset, the long-term market was most important to the Central Bank but as the money market and the foreign exchange market developed during 1992 and 1993, the Bank began to focus its activities on them. The Central Bank's instrument rate is now the yield it requires on repurchase agreements with credit institutions. This arrangement is similar to the most common practice among industrial countries, and is based on the premise that central bank instrumental rates largely determine money market rates. Money market rates then influence price developments, with price stability being the ultimate objective, through two channels. First, they have a strong direct impact on currency flows and the exchange rate when capital movements have been liberalized. Second, they affect the interest rates of deposit banks and the entire interest rate spectrum, which in turn influences consumption and investment and thereby affect the level of demand on goods and labour markets. Thus, the Central Bank achieves its objective whether it targets prices directly or indirectly by having the exchange rate as an intermediate target.

The changes that the Central Bank implemented at the beginning of March concerning repurchase agreements had two components. On the one hand, the definition of the collateral that qualified for repurchase agreements was widened to include again, after an intermission, all market listed government guaranteed securities and central bank certificates of deposit. The purpose of this change is to level the positions of the various government securities, as varying positions in regard to liquidity transactions with the Central Bank can influence their relative market yields. It is clear that such limitations do not exist among Iceland's neighbours. In addition, the stock of outstanding Treasury bills has shrunk in the recent period, which has caused a shortage of these bills for deposit banks to use in their repurchase agreements with the Central Bank. The other change is, as mentioned before, that the practice of offering repurchase agreements on tap has been abolished and replaced by a weekly auction of the agreements, as is done in many industrial countries. The Central Bank can at its discretion choose to auction reverse repurchase agreements instead of straightforward repurchase agreements.

Neither of these changes alters the course of monetary policy. However, they did have the effect of reversing the rise in money market rates that had occurred in January and February, when the interbank rate rose to 8.3 percent because of the shortage of Treasury bills on the market. This moved money market rates back to the level the Central Bank had aimed for when it set its interest rates in November, a range of 7.2-7.4 percent. It is always debatable what is precisely the right level of money market rates in light of the situation on and prospects for the foreign exchange market in the short run and for the goods and labour markets 1-2 years hence. The Central Bank's current assessment is that the level of the interest rate set in November provides sufficient restraint to ensure price stability in the period ahead. However, this assessment is under constant review in light of the development of a host of indicators.

Foreign Exchange Market

The foreign exchange market was reorganized in 1997. The exchange rate quotation meetings were abolished and replaced by a continuous market. Furthermore, market participants other than the Central Bank, now six institutions, replaced the Bank as market makers on this market. The arrangement is now similar to that among many neighbouring countries. The Central Bank's transactions on the foreign exchange market are now always at its own initiative, and should be view as intervention aimed at influencing the exchange rate. The new market arrangement has greatly improved the flow of information about market conditions and made the market more active. Also, all information about pressure on the exchange rate now appears instantaneously and the volume of transactions has grown sharply. Total turnover on the foreign exchange market was 162 billion kronur in 1997, and had doubled since 1996. In addition, the participation of the Central Bank in foreign exchange market transactions fell from 82 percent of turnover in 1996 to 37 percent in 1997. So far this year turnover has continued to increase and the share of the Central Bank has declined to 13.2 percent. Average daily turnover has been about 2 billion kronur this year. Daily fluctuations in the exchange rate increased as a result of last year's change, but not much when compared to what is common among other countries. Since mid-1993, or for almost 5 years, the exchange rate of the krona has never deviated more than 2.1 percent from the central rate.

Yields on Domestic Markets

Money market yields declined in the course of the year until the Central Bank raised its rates in November after which they rose. Yields on 3-month Treasury bills rose to 7.22 percent where they stood at year-end. A low Treasury borrowing requirement at times caused a shortage of Treasury bills. Demand for Treasury bills was also boosted because of increased interest in them for liquidity management.

Yields on indexed bonds changed little during the first half of 1997 but during the second half the yield on government bonds and housing bonds fell sharply, albeit unevenly. This decline was partly the result of the low Treasury borrowing requirement. The yield on non-indexed government bonds also declined sharply in 1997, although also unevenly, to 8.3 percent at year-end. Yields on both indexed and non-indexed bonds have continued to fall this year, with the yield on government guaranteed indexed bonds now well below 5 percent which some had regarded as the floor.

Although money and bond market yields declined in 1997 the lending rates of commercial and saving banks changed little. These rates have now begun to come down.

Profitability of deposit institutions

The profitability of banks improved during 1997. Current information on profits of the commercial banks shows a substantial increase compared with the preceding year. Their combined return on equity was 9.2% in 1997, compared with 8.2% in 1996 and 5% in the year before that. Nonetheless, profitability varied widely among them, and the different conditions that they faced complicate comparisons. Landsbanki (the National Bank) and Búnaðarbanki (the Agricultural Bank), for example, incurred large irregular expenses related to the final settlement of their pension obligations, which cannot be expected to recur in future. Provisions to reserves for loan losses have fallen sharply among all the banks. At the same time, the six largest savings banks recorded some decline in profitability compared with the previous year, and their return on equity was 8.5%. I should underline, however, that profitability varied widely among individual savings banks.

Reforms to the Banking System

There now appears to be widespread agreement that efficiency needs to be improved in the banking system in order to lower costs and make domestic banks more competitive in relation to foreign competitors, which will seek a market share in Iceland. It is necessary to take advantage of the opportunity provided by the incorporation of the state banks into limited liability companies and the prospective sale of shares in them. Certain goals need to be kept in mind. Effective competition on financial markets needs to be secured, although the merger of institutions should not be excluded if it can improve efficiency and profitability. The important question arises whether the state as owner of three strong institutions should take the lead in the necessary restructuring or whether powerful institutional investors are needed to do the job. Foreign investors with experience in banking are one option. The latter approach may, however, prevent the Treasury from realizing the full value of its assets in the banking institutions. The wide distribution of share holdings will also undoubtedly be an issue in the debate. This is by no means a simple matter and desirable goals may not be fully consistent. The main goal must be to ensure effective competition and efficiency improvements in the operation of credit institutions.

Pension Funds

It is estimated that the assets of the pension funds which are available to pay pensions, stood at 345 billion kronur at the end of 1997, an increase of more than 39 billion kronur, or 12.7 percent, in the course of the year. The composition of pension fund assets has change somewhat. Holdings of market listed securities expanded by 25.6 billion kronur while holdings of other securities declined by 3.7 billion kronur. At the end of 1997, the pension funds held 21.7 billion kronur worth of domestic shares. The pension funds' holdings of foreign securities grew sharply in 1997, or by 12.6 billion kronur, about one-half of which was in shares. At the end of 1997, the pension funds held foreign securities valued at 22.2 billion kronur.

Payment Intermediation

Over the last two years, the Central Bank has increasingly turned its attention to payment systems, both to specific payment forms and to settlement systems. The Bank has released two reports on this subject, one on electronic payment forms and another on a comparison of payment intermediation in Iceland with international practice. In recent years there has been growing international concern that settlement systems do not adequately take into account settlement risks. Two responses have been adopted. First, strong conditions have been imposed on net settlement systems which lower risk, and plans have been laid for the contingency that a settlement party is unable to meet its obligations. Second, net settlement systems have been abandoned in favour of real-time settlement, in which each transaction is recorded immediately and permanently, rather than transactions being netted, for example, at the end of the day. It now appears to be generally accepted that settlement systems, where the central bank provides settlement services, should be real-time systems. In light of this, in 1997 the Central Bank began in co-operation with financial institutions a review of domestic settlement systems with the view of bringing them into line with best international practice. The aim is to establish a real-time settlement system in 1999. The operation of a real-time settlement system will be a precondition for participation in the European Central Bank's TARGET settlement system should it become available.

Financial System Stability

Securing the sound operation of financial institutions is a task of steadily growing importance for the Central Bank. By law, the Central Bank is required to protect the monetary system and support sound money and securities transactions. Central banks pursue this task in a variety of ways. They carefully follow those macroeconomic developments, which impact money flows and thus the profitability of financial institutions. Securing payment and settlement systems is a central bank task across the world. Central banks are also lenders of last resort to financial institutions and need to be prepared to lend resources in excess of what would normally be required. The Central Bank of Iceland has partly performed this task through its Bank Inspectorate which has been built from the ground up in the Bank and is closely linked to some of the Bank's other activities, for example in regard to a joint database. Parliament is currently debating draft legislation, which calls for the creation of a new supervisory institution, which would combine all supervision of financial institutions. I cannot deny that the Central Bank is opposed to these ideas for reasons I discussed at this venue last year, and I shall not go into the issue in any more detail now. However, since the government's wishes in this matter became clear the Central Bank has co-operated wholeheartedly with the Ministry of Commerce in preparing the best possible legislation in this area and in securing the necessary link between the Central Bank and the new supervisory institution and also to ensure that The Central Bank will have all necessary opportunities to guard a sound and effective financial system. In some central banks, which do not have supervision among their responsibilities, such as in Sweden and the United Kingdom, much work has been put into defining the relevant tasks of the central bank. The Central Bank is bound to seek models in these countries when it becomes clear that the Bank Inspectorate will depart.

European Monetary Union

There are now 9 months until the member countries of the European Union, which meet the requirements of the Maastricht Treaty and become members of the European Monetary Union, adopt a new currency, the euro. There is now little to suggest that this will not happen on January 1, 1999 and the European Central Bank will be established this coming July 1. The Central Bank has thought it necessary to follow these developments closely, not least in order to be able to analyze the impact on Iceland and the options available to Iceland in the new environment. In June 1997, the Central Bank released a report *European Monetary Union, Creation and Impact*. The Bank will release interim reports on this issue as the occasion warrants. At this stage, it is premature to say what impact the Monetary Union will have on Icelandic exchange rate policy or on the options Iceland will face. I will, nevertheless, say a few words about the subject as it appears from the perspective of the Central Bank. The outlook is now that 11 countries will form the Monetary Union at the outset. These countries account for only 33 percent of Iceland's external goods trade. The initial impact will therefore not be nearly as significant as has been suggested in the domestic debate. Only when the United Kingdom joins the Monetary Union will more than one half of Iceland's goods trade be with countries in the union.

But which options will we have as regards exchange rate policy when the Monetary Union has come into existence? Theoretically the options are: 1) the current system; 2) a floating exchange rate; 3) a unilateral link with the euro; 4) a bilateral link with the euro;

and 5) introducing the euro as legal tender in Iceland. This list does not include membership of the Monetary Union, as that is only available to members of the European Union.

Three factors need to be considered when weighing these options: first, the success they will produce in terms of low inflation and economic stability; second, how likely are they to narrow interest rate differentials vis-à-vis abroad; and, third, the flexibility they offer in case of external shocks, whether positive or negative.

The current arrangement calls for the maintenance of a trade-weighted exchange rate index within 6 percent on either side of a central rate. The arrival of the euro will not prevent the continuation of this arrangement. The euro would be assigned a weight in the currency basket consistent with the Monetary Union members' share of Iceland's external trade. This approach will, however, not yield any progress towards narrowing interest rate differentials vis-à-vis those abroad beyond the growing credibility that economic stability will achieve on its own in due course. In addition, the experience of recent years, most recently from Asia shows that it has become more difficult to maintain a stable exchange rate with the liberalization of capital movements and ever larger and more active international financial markets. A response to this would be to allow the exchange rate to float, but in order to maintain low inflation and achieve narrower interest differential vis-à-vis abroad this would call for the adoption of a direct inflation target with the Central Bank entrusted to pursue it.

A unilateral link to the euro is hardly an option, as it would yield little in terms of greater credibility of stability and narrower interest differential vis-à-vis those abroad. In addition it has the drawback of not reflecting the composition of Iceland's external trade, at least for as long as the United Kingdom remains outside the monetary union. A bilateral link would be better, as it would enhance credibility by virtue of the commitment of the European Central Bank to defend the link, and would result in narrower interest rate differentials. The exchange rate risk premium would not vanish entirely because the commitment of the European Central Bank would never be without limits and conditions. It should be pointed out that it is unclear if and when the European Central Bank will be willing to discuss the possibility of bilateral co-operation with countries outside the union. Exchange rate changes could still take place in the case of a bilateral link with the euro. Only if the krona were abolished and replaced as legal tender by the euro, in a similar manner as Panama and Liberia have done with respect to the dollar, would exchange rate risk and the associated interest rate risk premium disappear. However, it is good for thought that no country with its economy in good order has chosen this path. Seignorage then accrues to another country or group of countries and all influence over monetary policy is surrendered. Nor is it clear that such a path would be acceptable to the European Central Bank. Participation in the Monetary Union would be a preferable option to adopting the unions currency unilaterally as this would allow for a share in seignorage and give the possibility for influencing monetary policy decisions. This would, however, require membership of the European Union as I mentioned earlier and any decision in that regard of course concerns wider issues than only monetary and exchange rate arrangements.

This is of course a very general analysis of the options we face, but nevertheless shows that the issue is more complicated than we are sometimes led to believe. All the alternative options have strengths and weaknesses. Also, future developments and what will actually be on offer are still in doubt. One reason is that the European Monetary Institute, the precursor of the European Central Bank, has not been empowered to discuss linkages with any non-member of the European Union. The task of preparing Monetary Union has been more than sufficient. Until these matters are clarified, the best thing for Icelanders to do is to contain inflation and preserve economic stability in order to be able to choose among future options from a position of strength. The experience of others has shown that there are no instant solutions when it comes to the exchange rate and that what matters are strong fundamentals and steady economic management.

Concluding Remarks

Ladies and gentlemen,

At present, the Icelandic economy is reasonably well balanced. The outlook is nevertheless for a current account deficit in 1998 for the third year in a row. Price increases remain very moderate and there are still no signs of general wage drift although it can be spotted in certain sectors. Economic growth will continue to be high. It is likely that the slack that existed in the economy when the recovery began has now disappeared. Strong growth will stimulate demand for goods and services and fuel the danger of cost increases being translated into price increases. The implications is that there is a danger of overheating. Therefore, the Central Bank will continue to pursue a tight monetary policy.

Finally, I would like to express my thanks for the pleasant co-operation the Central Bank has had with the government and financial institutions in Iceland.