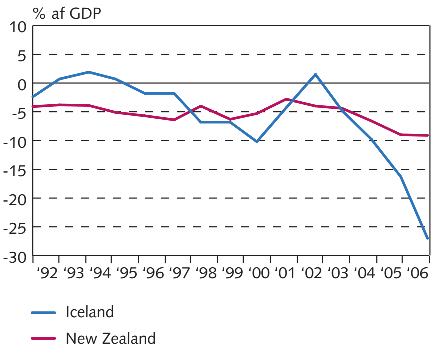
Appendix 2

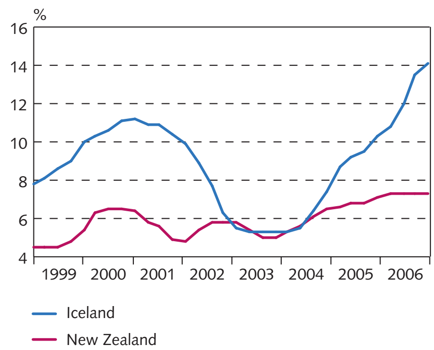
Similar economic situations in Iceland and New Zealand

Chart 1
Current account deficit 1992-2006



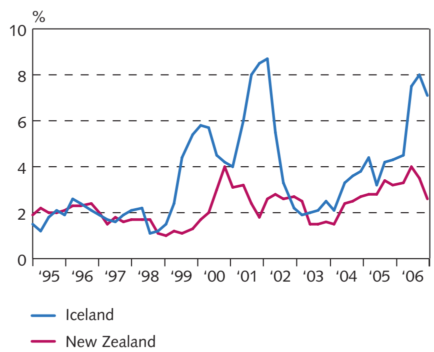
Sources: Reserve Bank of New Zealand, Central Bank of Iceland.

Chart 2
Policy rate 1999-2006
Quarterly averages



Sources: Reserve Bank of New Zealand, Central Bank of Iceland.

Chart 3
Inflation 1995-2006



Sources: Reserve Bank of New Zealand, Central Bank of Iceland.

Iceland and New Zealand are in many respects in broadly the same economic position. After a period with robust GDP growth, both economies are characterised by macroeconomic imbalances reflected in, among other things, a wide current account deficit, tight labour market and buoyant domestic demand growth. Surging private consumption in both countries has been mainly driven by growing household debt secured against greater housing wealth, after structural reforms in the mortgage market and increased demand sent house prices soaring. Both countries' central banks have countered mounting inflationary pressures by tightening the monetary stance. The interest rate differential with abroad has widened rapidly and attracted foreign investors. As a result, both countries are popular targets for carry traders and have witnessed large issuance of offshore bonds in their own currencies. International institutions have expressed concern about lax fiscal policy in both countries despite rapid reductions in public sector debt, and have called for a better fiscal and monetary policy mix. Discussions of monetary policy effectiveness have also been lively. Ideas for new measures in monetary policy conduct have been raised in both countries as well.

Greater imbalances in Iceland

However, the economic position in both countries is not identical. Imbalances are noticeably more pronounced in Iceland than in New Zealand. Iceland's current account deficit in 2006 was more than twice the size as a proportion of GDP, as were the inflation rate and policy interest rate. The composition of their current account deficit also differs. The deficit on the income account weighs heaviest in New Zealand, while in Iceland the largest deficit is on the merchandise account.[1] Also, inflation targeting appears to provide a better anchor for inflation expectations in New Zealand, where the inflation rate has been both lower and more stable over the past decade. New Zealand became the first country to move onto a formal inflation target in 1990.

Slower adjustment than forecast by central banks

The central banks in both countries face similar challenges. Their focus is on unwinding the macroeconomic imbalances that generate inflationary pressures. The Reserve Bank of New Zealand (RBNZ) raised its official cash rate in March 2007, the first hike since the end of 2005. The rate of output growth in 2006 came as a surprise to the RBNZ, which had forecast a faster adjustment of domestic demand. One explanation for the slower adjustment is that house price inflation, which

1. The deficit on the income account has been growing rapidly in Iceland and could assume a greater share of the current account deficit over the next few years, see Box VII-1 on p. 45.

was on the decrease in the first half of 2006, has declined more slowly than forecast after an upswing in the housing market. The fiscal stance has also been eased.

Similarly, demand has been adjusting more slowly in Iceland than the Central Bank had forecast. Investment has been underforecast and slower house price disinflation and a lax fiscal stance have also played a part, as in New Zealand.

Correlation between the króna and NZ$ dollar exchange rates

The New Zealand dollar and Icelandic króna have been highly sensitive to shifts in international financial conditions, and at times their exchange rate movements have been quite closely in step (see Chart 5). The correlation indicates the impact of carry trades involving assets denominated in the respective currencies. Large issues of bonds in these currencies by non-residents will mature in 2007 and could conceivably affect the countries' exchange rates.

Test of the monetary authorities' ability to promote stability

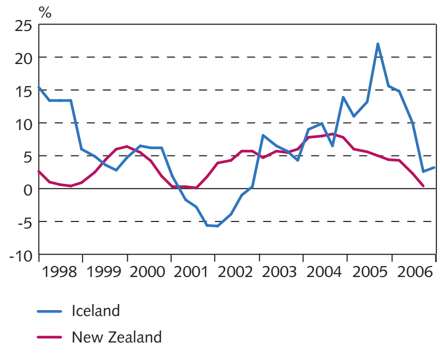
RBNZ staff, in cooperation with outside experts, have studied whether more balanced external trade and exchange rate stability can be realised without compromising the bank's main function of contributing towards inflation on target. Although not conclusive, the findings do not invite fundamental changes to the RBNZ's monetary policy objectives or framework.[2] An increased emphasis on ensuring exchange rate stability could amplify volatility of inflation and output growth. Just as in Iceland, however, there is scope for strengthening the monetary policy transmission mechanism by increasing Treasury bond issuance and other measures.

Call to step up Treasury bond issuance

New Zealand and Iceland are the most heavily indebted countries within the OECD, but only a small share of their external debt is accounted for by central government. Thus the Treasury borrowing requirement in both countries has shrunk rapidly, with a corresponding decrease in bond issuance. The governor of the RBNZ has underlined that the Treasury should nonetheless continue to issue bonds in order to bolster price formation in financial markets and facilitate the monetary pass-through. The Central Bank of Iceland has likewise emphasised the importance of this role for the Icelandic Treasury.

Chart 4

National expenditure growth 1998-2006

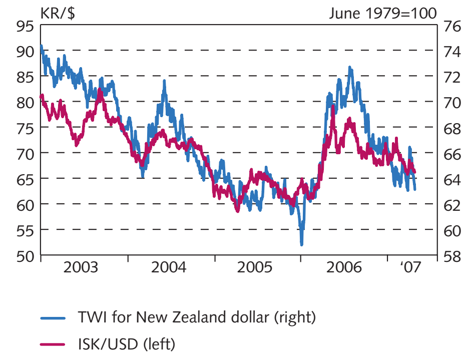


Sources: Statistics Iceland, Reserve Bank of New Zealand.

Chart 5

Exchange rate of the króna against USD and TWI for New Zealand dollar

Daily data, January 1, 2003 - March 27, 2007



Sources: Reserve Bank of New Zealand, Central Bank of Iceland.

2. See New Zealand Treasury and Reserve Bank of New Zealand (2006). *Testing stabilisation policy limits in a small open economy: proceedings from a macroeconomic policy forum.*