Box 3 Are there grounds for Iceland to maintain a similar monetary stance to the USA?

Recently comparisons have frequently been made between monetary policy stance in Iceland and the USA. Since the beginning of this year the Federal Reserve has cut interest rates six times, by a total of 2.75 percentage points. The federal funds rate stood at 6.5% at the beginning of the year, and had then been unchanged since the previous spring, but is now 3.75%. Central Bank of Iceland policy interest rates peaked at 11.4% over the period November 2000 to March 2001. At the end of March they were lowered by 0.5%. A question which has been frequently asked is whether this difference between Icelandic and US interest rates is warranted, e.g. in light of the fact that economic growth is now slowing down in both countries and is forecast to be at similar rates this year. Closer scrutiny, however, reveals many differences. Firstly, inflation is much higher in Iceland, as the accompanying table shows. This means that despite the 7.15 percentage points differential between the Icelandic Central Bank rate and the federal funds rate, the real differential is much less, at 3.2 percentage points based on inflation over the past 12 months.

As the chart shows, the two countries differ in more than their inflation rates. Most indicators suggest that the Icelandic economy is much more overheated. For example, the difference in wage developments is striking. Over the period from 1996 to 2000, wages in Iceland rose by 18% more than productivity. In the USA productivity outstripped wages over the same period. This means that there is much less risk of wage increases leading to higher inflation in the USA than in Iceland. This pattern reflects the situation in the labour market. Unemployment was at a historical low in the USA last year, and went as low as 3.9%. Over the past half a year it has been rising again and stood at 4.6% in May. In Iceland unemployment figures have been much lower. Registered seasonally adjusted unemployment reached a low of just over 1%, but lay in the range 2-2½% according to labour market surveys comparable to those in the USA.[1] Seasonally adjusted unemployment in Iceland has risen slightly of late, but is still very low.

The impact of Iceland's much higher wage increases on the inflation outlook is magnified by the particularly unfavourable development of the króna, which for example weakened by one-fifth over the period May 2000 to May 2001. The US dollar appreciated in effective terms by 7% at the same time, according to IMF calculations, and by much more on a longer-term view. The dollar has not been stronger since the mid-1980s, which is actually too much of a good thing from the point of view of US businesses and the external balance of the economy. The exchange rate has contributed to keeping inflation in check in the USA, but kindled inflation in Iceland. Despite the lower US interest rate, the dollar has remained strong, in fact undesirably so. The Federal Reserve can cut interest rates without much concern about the impact of exchange rate developments on prices. In contrast to the Central Bank of Iceland's concern about inflationary conseqences of a depreciation of the króna, even if the dollar were to weaken substantially, the Federal Reserve can afford to look at the dollar exchange rate with benign neglect. The US economy is relatively closed and self-sufficient (although it has opened somewhat in recent decades).[2] Iceland not only has a much higher proportion of foreign trade to GDP, but also profoundly lacks diversification of production and domestic competition. Changes in the exchange rate are therefore transmitted much more quickly to Icelandic prices.

The strong real exchange rate and large current account deficit in the USA suggest that the dollar may depreciate considerably over the years to come. The

1. Such employment surveys are only conducted in Iceland twice-yearly.

2. Only 10% of changes in the exchange rate of the dollar are transmitted to US consumer goods import prices within one year. The impact of a 10% depreciation of the dollar on the consumer price index in the USA is therefore only a fraction of 1%, compared with approximately 4% in Iceland. On the impact of exchange rate changes on US import prices, see Maurice Obstfeld and Kenneth Rogoff (2000), "Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment", paper presented at a conference organised by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 24-26, 2000.

Comparison of economic conditions in the USA and Iceland

%	*USA*	*Iceland*
Latest central bank policy interest rate	3.7	10.9
Latest annual inflation	3.6	7.0
Real policy interest rate based on latest inflation	0.1	3.8
Forecast inflation, % between 2000 and 2001	3.1[1]	6.4
Wage increases 1996-2000	12.7	31.4
Rise in wage costs per unit production, % 1996-2000	-1.8	17.9
Exchange rate trend May 2000 - May 2001[2]	6.6	-21.4
Average GDP growth 1996-2000	3.4	4.5
Forecast growth 2001	0.7[3]	1.5[4]
Output gap 2000	2.2	2½
Unemployment as % of labour force[5]	4.6	1.6/2-2½
Current account deficit 2000, % of GDP	4.5	10.3
12-month credit growth, Latest figures	4.7	25.9
Accumulated 3-year credit growth	27.0[6]	81.0

1. IMF Forecast, May 2001. 2. Average US$ exchange rate as per *IMF, International Financial Statistics*. Average kr. rate as per Central Bank of Iceland official exchange rate index. 3. Consensus Forecast, May 2001. 4. National Economic Institute of Iceland, June 2001. 5. Based on June 2001. 6. Foreign lending weighs heavier in total lending by US financial institutions. Excluding this component would give a considerably lower figure for credit growth in the USA in recent years

long-term outlook for the exchange rate of the króna has been even weaker, and explains its less favourable development. There are few reasons to believe that the exchange rate of the króna was more misaligned than the dollar is today when it peaked in real terms last year, far from it. However, Iceland's current account deficit last year was more than double that of the USA. The closer correlation between exchange rate and prices in Iceland means that monetary policy must pay much more heed to conceivable impacts on the króna. A persistent current account deficit may make it unavoidable to maintain a sufficiently high interest differential with abroad as to make the Icelandic króna attractive for investors to hold. Otherwise there is a risk of even further depreciation while the adjustment of domestic demand is in progress.

A comparison of lending growth is no less striking. Lending has been growing fairly rapidly in the USA in recent years. In 1998 and 1999, twelve-month lending growth by US credit institutions to domestic businesses (excluding other credit institutions) was in the range 6½-7%. Growth slowed down considerably last year and has recently been around 4½-5%. By comparison, lending growth within the Icelandic credit system amounted to around 20% last year and lending by DMBs increased by almost 35% when the growth rate peaked in 1999. Since then, credit growth has not fallen below 25%, although part of last year's figure can in fact be attributed to the revaluation of loans linked to the exchange rate or price index.

All the above goes to show that economic conditions in Iceland are very different from those in the USA. There are many indications that the USA is on the brink of recession. The underlying economic trend in the US economy leaves the Federal Reserve fairly well placed to stimulate economic growth by lowering interest rates. Given wage and productivity developments in recent years, excess capacity and the strong position of the dollar, the Federal Reserve can ease the monetary stance, fairly confident that it will not lead to higher inflation. In Iceland, there are various signs of a slowdown or even a recession in the near future. The NEI's measurements of GDP for Q1, however, still indicate robust growth of more than 7% since Q1/2000, although this may possibly be the product of temporary factors. The bottom line is that macroeconomic imbalances in Iceland that need to be unwound are much larger. This invites the conclusion that, however worthwhile it may be for the USA to attempt to stave off a recession by easing the monetary stance, it should not be taken for granted that such an objective is realistic or even desirable in Iceland. Given the scale of the overheating of the Icelandic economy in recent years, a temporary contraction of output may regrettably be the price that has to be paid for the excesses of the past, in order to prevent inflation from becoming too entrenched and to secure that the Central Bank's inflation target is attained within an acceptable horizon.