Speech by Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a seminar organised by the Iceland Chamber of Commerce, December 5, 2005

On December 2, 2005 the Central Bank of Iceland raised its policy interest rate by 0.25 percentage points before last weekend. I do not expect that decision came as a surprise. Some people may well have read into what the Bank wrote in connection with the policy rate hike in September that the increase this time would be greater, by 0.50 or even 0.75 percentage points. No such decisions were embodied in those writings, although the Bank made a clear commitment that it takes its mandatory role seriously and would not flinch at following it with full force. Those declarations stand firm.

Monetary Bulletin, which was published on the Central Bank's website last Friday, includes a detailed account of the Bank's assessment of economic and monetary developments and prospects, and the arguments underpinning its decision to raise the policy interest rate now.

The scenario that we faced on September 27 has changed in several ways. Uncertainty about wage settlements has been dispelled, although admittedly at considerable cost. The consumer price index fell somewhat at the last measurement. House price inflation has slowed down and there are signs that a turning point has been reached. Credit institutions are now proceeding more cautiously in their lending to this sector and interest rate terms are changing. Oil prices seem to be stabilising, and in spite of mounting labour market pressures, wage drift has been contained. The Central Bank's policy rate hike is beginning to spread through the economy; monetary policy is transmitted with an inherent lag in all cases, and this has even been exaggerated by Iceland's unique economic conditions at present. The most important change in the wake of the September policy hike, however, was that indexed bond yields began to rise at last. It was vital for monetary policy to begin to have an effect in the parts of the economy which showed the clearest signs of overheating, i.e. soaring private consumption growth.

Although all these points represent an interesting and positive development, on their own they do not justify changing the policy that the Central Bank has been pursuing. Substantial pressures still exist in the economy, demand is buoyant and there are undeniably sizeable imbalances. These factors must be seen in context. While recent information on the short-term outlook should obviously be observed, it is even more vital to look at indicators for longer-term developments.

In effect the Central Bank has no other option – like God's mills, the Bank's instruments grind slowly, but grind exceedingly well, if patience and foresightedness guide the way. The Central Bank has made no secret that the current strength of the króna is not sustainable in the long run. An important change this autumn and so far this winter has been large-scale issues of króna-denominated bonds in international markets. In particular, these issues are driven by the wide interest-rate differential between Iceland and other developed countries. The current *Monetary Bulletin* attempts to analyse the impact of these issues, including a separate article dedicated to this topic. Their impact can be positive. For example, it can lead to more efficient foreign exchange and securities markets in Iceland, thereby benefiting domestic economic developments. However, the issues can also – at least temporarily – create uncertainty about the transmission of monetary policy and even intensify its impact effect through the exchange rate channel. Such a pass-through hits export sectors hard, while doing little to subdue private consumption growth.

One standard assumption underlying the inflation forecast published in the current *Monetary Bulletin* is that the policy rate will remain unchanged from the day of forecast. On the basis of this scenario, the Board of Governors decided to raise the policy rate by 0.25 percentage points. The Central Bank's monetary policy over the medium term will need to ensure that the exchange rate adjustment which appears inevitable in the long run does not result in a higher rate of inflation than is compatible with the target. A tight monetary stance will be required to do so, for as long as capacity and labour market pressures pose inflationary threats. Furthermore, a sufficiently wide interest-rate differential with abroad must be maintained to contribute to a smooth exchange rate adjustment.

The surge in house price inflation has reached a peak. If the króna remains relatively strong and stable, goods prices are also quite likely to fall. Thus the outlook is for a slowdown in the inflation rate in the coming months, not least because the depreciation of the króna this year has only been passed on to the domestic price level to a limited extent. If the housing market cools more quickly than the Central Bank forecasts, house price inflation is likely to slow down even more sharply than is currently expected. Foreseeable exchange rate developments, an ongoing surge in private consumption and greater-than-expected rises in unit labour costs, however, will outweigh these factors in the long run.

The Central Bank has repeatedly cautioned against ideas that the inevitable difficulties accompanying a tight monetary policy can be avoided by abandoning the inflation target temporarily, or "letting inflation through", as it has sometimes been called. This is an unrealistic option. Such a volte-face in Central Bank policy would immediately push up inflation expectations, fuel even higher wage increases and catalyse a depreciation of the króna and more inflation. Ultimately the policy rate would need to be raised by even more to bring inflation back down. Businesses and households would suffer more rather than less from such a policy. Nor should it be forgotten that a large share of household and business debt is either price-indexed or exchange rate-linked. Due to this distinctive feature of the Icelandic financial system, even the short-term benefits to households and business from a more accommodative monetary stance could prove to be minimal or even negative.

However, a tight fiscal policy can contribute to a softer landing. Buoyant demand and soaring business profits have generated revenues for the Treasury this year far in excess of forecasts. A similar position could be on the cards in 2006. It is vital for both central and local government authorities to respond to this boost in revenues not by easing their restraint on the expenditure side, but rather by planning to achieve increased surpluses, which appears to be the aim behind the budget currently before Parliament.

As announced recently, a change will be made to monetary policy implementation whereby interest decisions will be made on six fixed, preannounced dates next year. Three will coincide with the publication of *Monetary Bulletin*. On all these dates, the Board of Governors will announce its decision at a press conference, irrespective of whether the policy rate is changed or not, together with supporting arguments. This change will make monetary policy even more transparent. The Central Bank can thereby be said to have increased its formal interest rate decision dates from four to six, because the publication dates for *Monetary Bulletin* were already recognised as such in effect. Nonetheless, the Board of Governors can of course decide to change interest rates in between the preannounced dates if this is considered justified. The first formal interest rate decision date next year will be Thursday, January 26.

Icelandic economic conditions at any given time broadly correspond to what is going on elsewhere in the world. However, occasional tasks can differ and call for specific measures. This is what we see from the Central Bank of Iceland's policy rate at the moment. It is not reflected anywhere else. The explanation is that the picture in Iceland is unique, and maintaining a low and stable inflation rate in the current climate would widely be thought an ambitious aim.

First, the largest single investment programme in Iceland's history is now under way, and Landsvirkjun and its foreign business partners are by no means the only investors planning major projects.

Second, we are simultaneously experiencing the largest-ever overseas expansion of the Icelandic banking system, which has accumulated foreign debt on an unprecedented scale with accompanying capital inflows.

Third, the Icelandic credit market has been sharply transformed, with an open invitation for everyone to join in.

Fourth, tax cuts have been implemented or announced for the coming months. And to add the icing to the cake, wage earners are compensated for the inflation caused by the broad rise in their house prices which has taken place at no cost to them.

This is the climate in which we aim to ensure that medium-term inflation will obey the principles set for it in the Central Bank Act and the joint declaration by the Central Bank and Government of Iceland. This must surely be considered an ambitious goal. Sizeable imbalances can be seen in the global economy. The massive US current account deficit is eating up a large share of total global saving at present. Managed exchange rates elsewhere, for example in China, delay markets in responding to this problem. Economists claim that a change is inevitable, and the later that it comes, the more upheaval it will cause when it eventually does. As far as Iceland is concerned, however, external conditions have been favourable so far. It enjoys high creditworthiness and wide open access to markets. Interest rates have been low and product prices high, making the strong position of the króna – which will not last forever – much easier than otherwise for many to weather. But we need to make sure that favourable external conditions in most areas do not become a fundamental precondition for our own success.

In my opinion – after only a few weeks at the Central Bank of Iceland – one of the main reasons that its management is employed there is to pay particular attention to risks in the economy. I shall mention the following illustration. Of course it is perfectly normal for progressive and rapidly growing banks, which feel constrained by the small size of the Icelandic market, to be eager for foreign capital in their efforts to expand and reap profits. The financial system infrastructure and all the criteria assessed by supervisory authorities and ratings agencies are in excellent shape. All markets should therefore stand open to Icelandic banks for the foreseeable future. However. it is not necessarily certain that these important preconditions will be the only factors at work at any given time. They do so while market conditions are normal but markets can be volatile, especially in a climate of global economic imbalances. The US economy is very buoyant and dynamic at present. This is to be welcomed. However, other signs are less encouraging: a low level of saving, a wide fiscal deficit and a current account deficit that repeatedly hits record levels. Europe has still not recovered and the recent rise in the ECB minimum lending rate has been harshly criticised by those concerned about stagnation and growing unemployment. All these aspects of our environment call for normal caution to be exercised, not least against the background of such rapidly growing and increasingly prominent forays by Icelandic financial institutions in the international capital markets. Under such conditions we can endorse the comment by my colleague, the Governor of the Central Bank of Denmark, who said a few days ago that it was just as important to observe the speed limit in economic policy as on the roads.

Now I would like to allow myself a few words about housing issues. It is definitely easy to make a reasonable case that the Government could have considered the matter more carefully when it made radical changes to its housing policy at the onset of the upswing in 2003, and that it would have been more prudent to postpone them until the boom came to an end. (I presume people realise which Prime Minister this criticism is levelled at). But there are even stronger arguments for claiming that, in spite of the questionable timing, this represented a very positive reform to the housing system framework, which the Government can be proud of. However, the response by the banking system certainly caught the Government by surprise. As things have developed, this is now a secondary consideration. The banks’ response rendered the housing system in its old form virtually obsolete overnight, whether we like it or not.

Mortgage interest rates are admittedly still high in Iceland. That is by no means the most interesting point in the current debate, however. Access to credit and finance terms for buying or building housing in Iceland have never been better. But it seems obvious that a large part of the banking system is probably subsidising its own mortgage lending at the moment. Of course this may be a deliberate risk taken in the faith that, since such lending is long-term, lenders will eventually reap handsome profits when interest rates move into line with those in other countries. Disregarding such speculation, the competitive position in the housing market is clearly untenable when one player enjoys the same credit rating as the sovereign, does not pay fees for its Treasury guarantees and is exempt from various charges levied upon its rivals. It is quite true that the credit institutions already knew this when they aggressively intensified their participation in the mortgage market. But as I said, this is a secondary consideration now and the task ahead must be to normalise these arrangements as soon as possible.

Ladies and Gentlemen:

Since becoming Chairman of the Board of Governors of the Central Bank of Iceland I have now moved to a part of Icelandic society that attracts words of concern and caution from all directions. And I have a feeling that it is a sensible arrangement to assign such a role to a single body – but it must have the capability to assess the position and respond correctly. I hope that the Central Bank of Iceland is in such a position. It is certainly true that the Central Bank plays the same sort of role in an economic upswing as an air traffic controller, paying more attention to the landing than to the takeoff. But it is not true, as is sometimes implied, that the Bank does not care whether this landing will be a hard or a soft one.