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*In an interview with business newspaper Viðskiptablaðið on March 17, 2006, Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, said that the banking sector is on a strong footing and should face up to the dialogue about it:*

## **“Absurd to talk of a crisis”**

*– “There is nothing to hide and we do not need to glorify the picture”*

Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, dismisses talk of a crisis in the Icelandic banking sector and economy after recent reports by international analysts and banks which have sent tremors through the Icelandic equity and forex markets. “I don’t think this is a crisis – not even a hint of a crisis. I think that’s very important for people to realise,” Mr. Oddsson says.

“Really this involves certain very limited areas,” he continues. “The Icelandic banks have become quite dependent on foreign financing, which means they need to enjoy high confidence in the markets. They have to make a great effort to build up that confidence and maintain it. Some people have pointed out that the markets rate the banks lower than the international rating agencies do, and assume the agencies will bring their ratings into line with market perceptions. But it is interesting that the rating agencies are sticking to their views after examining the banking sector, and deem the banks to be sound and robust. If subsequent events turn out favourably, the market is more likely to move into line with the rating agencies’ outlook, and not vice versa.”

The Chairman of the Board of Governors is pleased with the Central Bank’s recent cooperation and dialogue with the banks. “We have urged the banks to slow down their lending. This is healthy for them. Such rapid growth brings growing pains – and with massive increases in both staffing and customers, for a while the banks might lack a clear picture of their employees’ abilities and their customers’ security,” he remarks.

### **Strong profits in recent years**

“An absolutely essential point that needs to be made in this debate is that the banks have reported very strong profits in recent years. People sometimes scoff about ‘paper profits,’ but the fact of the matter is that even if you disregard some of it as deserving that name – which of course is not always the case – it turns out that the banks have still been performing very strongly,” Davíð Oddsson says.

He points out that interest-rate margins have been narrowing in the banking sector, both because of the inclusion of foreign acquisitions in consolidations and tougher competition. “Risk spreading is improving too, which is a good thing. And defaults are steadily declining, which hopefully indicates that lending decisions have been well founded and contribute to lower levels of delinquency and write-offs,” he says. “All this is highly positive.”

Nonetheless, Davíð Oddsson says there is no justification for criticising the recent dialogue. “I think that such criticism is based on a misunderstanding. The banks should face up to the dialogue – take advantage of it – because in my view they are in the clear and can easily do so. They should welcome it and take part in it, because the figures we are looking at suggest that, broadly speaking, the banks are doing well. But they should also take account of the criticisms that have been made.

“First, the banks should clarify what they regard as misunderstandings, as many of the claims about them seem to be. Second, they should take account of other points that tarnish their image abroad, for example the consequences of over-rapid growth and possibly of cross-ownership. As far as I can tell the banks are taking account of all this and are acting responsibly,” Davíð Oddsson says. “If they do that, with the good foundation that they have, it’s absurd to talk about a crisis in the air. All this could well demonstrate yet again that if you survive adversity, you’re left all the stronger for it.”

### **Misinformed Scandinavian media**

*– Don’t you think the media coverage has been excessive?*

“I can’t deny that I’m a little unhappy with some of the Scandinavian media. Some of what I have seen is outrageous – even in media that I hold in high regard. It’s strange how misinformed, rash and even sometimes hostile this coverage is. I don’t like it and it’s unfair criticism.”

*So perhaps it all began with people abroad who are quite ignorant about the Icelandic economy?*

“There’s some truth in that. That’s why no one here should wait for the storm to blow over. They should get to work to make it blow over. In some respects they could clean up their own act a little and tread a little more carefully, but part of all this could just be normal competition – the banks are prominent in markets that used to be calm, and their rivals tackle them with every means at their disposal. There’s no need to complain about this debate. Just respond to it and tackle it.

“There is every reason to assume that the proper message will be put across in the end. There is no point in glorifying the picture – glossy pictures can be attacked and questioned. The truth is healthiest and we simply have nothing to hide. On the contrary.”

### **Warnings pay off in the end**

*Do you think the storm is over?*

“It was a wake-up call and I think that the Central Bank, the Financial Supervisory Authority and the financial institutions themselves took it seriously. In the long run I think that their response will serve to strengthen all these systems. In many respects the Icelandic banking sector is very solid and has made great progress, with much wider risk spreading than before and powerful internal auditing.”

*To turn to the position of the economy: Treasury spending has not gone down and the government is involved in extensive investments in power stations for the aluminium industry, which have a crowding-out effect and squeeze exporters. What’s it like being on the other side of the table [after retiring from politics] and having to use the policy interest rate to keep the lid on inflation? Isn’t that a difficult position to be in?*

“Someone once said that it serves me right, which I suppose is one way to put it. But the fact is that in the public sector, the central government has been repaying its debts. That isn’t the case with local governments, even though they have experienced the same upswing as the state. Treasury debt has virtually disappeared. If we balance off the Treasury’s external debt against the Central Bank’s foreign reserves – which of course belong to central government – the debt position is zero. Naturally that is a good position to be in, and a very helpful one when people talk about the banking sector in such terms, for example. In the background stands the central government sector with its extremely good debt position, better than in most other countries.

“Of course you could argue that tax cuts like those arranged by the present government are most suitable when the economy is tighter, but history shows us that no one cuts taxes then – the Treasury’s finances won’t allow it. If we followed that rule we would never cut taxes.

“I think that the government should go ahead and cut the taxes it has planned to cut, but at the same time be firm enough to oppose spending and build up deposits, for example in the Central Bank, while the boom is at its peak. In the long run I think the most important point is for the state not to have an unnecessarily large profile in the markets.”

### **Inflation must not be let through**

*What about the state’s investments in the power sector, to supply the aluminium industry?*

“In the long run the current investments in the aluminium industry will benefit the economy. They would not have been launched without being thought through to the end and nothing has emerged to suggest that those calculations were wrong.”

*The Central Bank completely rejects the idea of “letting inflation through”?*

“I don’t think we have a legal mandate for that. We are obliged to promote price stability and we consider that, in the long run, entrenched inflation costs households and businesses more than the effort to contain it. We don’t want to choose the sweet and easy way out.”

*But it’s tough on debtors.*

“It’s very tough, especially for people with difficult loans such as overdrafts, but then they should respond by trying to reduce them. The Bank’s measures are not intended to hurt people, only to prod them and encourage them towards saving for a while. A high rate of inflation would hit debtors. So they stand to gain directly if inflation is kept in check.”

### **Volatile euro exchange rate**

*There are drawbacks for a small economy which has its own currency, such as exchange-rate volatility. Is there no alternative?*

“We’ve seen great volatility in the dollar-euro rate too. Only between one-third and one-half of our merchandise trade is with the euro region. So we would certainly not get rid of volatility by adopting the euro; the only difference is that the volatility then would have nothing to do with the Icelandic economy. The króna moves to reflect certain economic conditions which will ultimately attain balance.

“If we were part of the euro region under the present circumstances, along with major nations like Germany which are in recess, we would face huge problems, because all monetary policy is based on their position. I think people are losing their bearings. I have even heard people who advocate adopting the euro for a few months, just while the króna is so strong. That’s utter nonsense.

“The most favourable arrangement for us is surely to have the possibility of allowing the króna to adjust to Icelandic conditions, rather than using a currency that adjusts to completely different conditions elsewhere. It’s really as simple as that.”

*To turn to one of the principles of monetary policy. The Central Bank has the sole right to issue legal tender and provide liquidity in Icelandic currency to the banks. This means that with little more than a stroke of a pen it can devalue households’ monetary assets by increasing money in circulation and raising interest rates for households and businesses. Is*

*this system fair? In your view, would it be worth considering to abolish the Central Bank's monopoly on money issuance and allow people to choose the currency they use?*

“In effect, people can use the currency of their choice much more now than before. For example, businesses are allowed to keep their accounts in foreign currency, which creates a certain amount of competition with the króna. People can take foreign currency-denominated loans, and do so in particular when they have income in those currencies. Private individuals can hold foreign currency accounts in banks. The Central Bank has ceased intervening directly in the value of the króna vis-à-vis other currencies, so there is much more scope now than before.”

### **Less need for direct control**

*This means that the Central Bank is less powerful.*

“Yes, the power of the state and the Central Bank in the financial sector has been significantly reduced. And there are many signs that it's an improvement.”

*Which makes it more difficult for you at the Bank to attain the inflation target.*

“Yes, it does as such, but on the other hand: although the Central Bank and state have less and less scope to influence the economy, their intervention is certainly needed much less now, because the economy handles things itself. While the economy was closed it needed to be controlled directly with all manner of instruments. The Central Bank does not have many instruments at its disposal as things stand today and I don't think it should abandon them. But there are people who believe the Central Bank should be abolished.”

### **Supervisory institutions have not grown on the same scale as business**

*Legal proceedings have been under way against certain influential businessmen and these are widely considered to have taken an unnaturally long time. Some people feel this has been detrimental to the business world and the economy, and created uncertainty. Should you have made more effort to strengthen these important institutions, the Economic Crime Department of the Police and the Office of the Director of Public Prosecutions, while you were in politics?*

It could well be true that the financial sector and the economy have grown so rapidly in Iceland that we have not matched this by building up the institutions that should provide safeguards and security; this has happened in other countries. Supervisory mechanisms expand much more slowly than the economy itself. Of course we hope to keep them to a minimum, but it is also good for everyone to know that the systems that are deemed necessary, such as the Financial Supervisory Authority

and the police force, have the staff, resources and funding to be able to perform their role quickly and effectively. It is a different question whether legal proceedings cases have been so lengthy for this reason or because parties to them have drawn them out themselves. I have simply not been watching them closely enough to be able to say either way.”

*A final question: How do you like being at the Central Bank?*

“I like it very much. It’s new for me, much of it is different from my previous jobs, but I like being here and enjoy tackling the tasks I’m paid to deal with.”

*It’s completely different from your previous job?*

“Completely different. Here we mull over matters and ponder them much more than in my previous jobs, which involved more or less non-stop decision-making. It makes a nice change to approach tasks differently. There’s a long process of preparation behind every single important decision.”

*And more privacy?*

“Yes, much more. Especially in the evenings and at weekends.”

*Have you got into the routine completely by now?*

“I’m still learning a lot and that will obviously continue, but there are plenty of good people here to guide me.”

*Wasn’t it difficult to switch over?*

“No, it was surprisingly easy. But perhaps for the first weeks and months you may need to spend more time on things that you hope will become more accessible and easier later. That applies to all jobs and everything you do.”