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Speech

Már Guðmundsson, Governor of the Central Bank
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Madame Prime Minister; Ministers; Madame Chairman; Directors and Ambassadors; Ladies and Gentlemen:

As we convene for the 52nd Annual General Meeting of the Central Bank of Iceland, the domestic economic recovery that began in mid-2010 continues, although it has slowed down in recent months. At least to a degree, the slowdown is due to developments internationally. The margin of spare capacity in the economy continues to narrow. Inflation has proven more persistent than previously hoped, however. Early on, wage increases far in excess of productivity growth played a leading role in raising inflation well above the inflation target, but since last autumn the weakening of the króna, triggered by deteriorating terms of trade and a heavy foreign debt service burden, has played a greater part. Monetary policy responded to these developments with interest rate increases beginning in August 2011. The Bank's interest rates have been unchanged since November, however, and intervention in the foreign exchange market has supported the exchange rate in the recent term, thereby supporting the monetary policy goal of bringing inflation back to target.

Global output growth lost pace in 2012, but to differing degrees in various regions. There was a contraction in the euro area and marginal growth in the UK and elsewhere in Europe. Among Iceland's major trading partners, weighted output growth measured 0.8% in 2012, as opposed to 1.7% in 2011. To a degree, the capital controls have shielded the Icelandic financial system from the euro area crisis. The effects felt through external trade were unavoidable, however, and Iceland's terms of trade deteriorated over the course of the year, while the import purchasing power of export revenues stagnated. This played a part in slowing down output growth, even though Iceland's growth rate was much faster than in trading partner countries.

According to preliminary figures from Statistics Iceland for 2012 as a whole, output growth measured 1.6% during the year, which is somewhat below the Central Bank's February forecast of 2.2%. On the other hand, year-2011 growth figures have been revised upwards, from 2.6% to 2.9%. This is well in line with the Central Bank's first forecast of GDP growth in 2011. It is not uncommon that output growth figures are revised upwards during upward cycles, when more detailed investment figures become available. It will be interesting to see how estimates of 2012 develop.

Output growth in 2012 was driven by growth in private consumption and business investment, while other items, such as net trade and public consumption, made a slightly negative contribution. This is similar to the whole recovery phase in 2010-2012, where business investment and private consumption contributed to output growth more or less equally, with business investment holding a slight advantage. Last year's growth was sound in the sense that it was not "borrowed" but based on an underlying current account surplus measuring almost 4% of GDP.

In spite of the slowdown in GDP growth last year, the slack in the economy continued to diminish. The economic recovery is continuing, with current forecasts providing for GDP growth of over 2% this year and in the 3½-4% range in 2014 and 2015. Labour market statistics support this forecast of a diminishing slack in the economy. For instance, seasonally adjusted unemployment measured 4½% of the labour force in February, its lowest point since November 2008. A survey carried out regularly by the Central Bank in collaboration with the Confederation of Icelandic Employers shows that, for the first time since March 2008, respondents wishing to recruit staff members outnumber those interested in downsizing.

The slack in the economy still exists, but these developments, together with disappointing inflation figures (which I will mention again later on), give rise to the question of how big that slack is. Every time they take a decision on interest rates, monetary policy decision-makers must ask themselves this question, as previous economic policy mistakes in Iceland and elsewhere – mistakes that have ended in inflation and instability – have often originated in an overestimation of output slack and potential output growth. It is vital to seek out structural reforms that could result in higher growth potential, and important work in that direction is currently underway. But it is equally important not to give rise to unrealistic expectations about how fast potential output can grow. The Central Bank's analysis and forecasting work always aims to answer this question, which is one of the most important in monetary policy implementation.

Inflation subsided somewhat in 2012, falling from 6½% at the beginning of the year to just over 4% at year-end. The Bank's February forecast assumed that this trend would continue, provided that the króna did not weaken further. According to the forecast, inflation should be close to target around the middle of next year. Whether that happens earlier or later depends primarily on developments in the exchange rate. It was therefore a disappointment to see how much prices rose in February, raising twelve-month inflation once again. It is always imprudent to read too much into individual measurements, and it has yet to come to light how much of that increase was based on temporary factors. Furthermore, the exchange rate has risen more than 5% since the beginning of the year, which could affect the next measurements. Nonetheless, this inflation measurement gives good reason for caution, and if the role of temporary factors proves smaller than might appear at present and inflation declines to the target more slowly than previously forecast, it will be necessary, other things being equal, to withdraw monetary accommodation sooner than would otherwise be required.

The Central Bank's interest rates have been unchanged since November 2012, when they were raised by 0.25 percentage points. In its November statement, the Monetary Policy Committee implied that the Bank's nominal rates could remain unchanged in coming months if developments were in line with the forecast and no additional pay rises were negotiated during the wage settlement review early this year. This has been borne out so far, and the Committee kept rates unchanged at its December, February, and March meetings.

At present, the Central Bank's effective real interest rate is positive by just under 1%. Although it has risen by nearly 2 percentage points in the past year, it is still below the equilibrium real rate once the economy has recovered and the slack has disappeared. If the economic recovery maintains its pace in coming months, it will therefore be necessary to withdraw the accommodative monetary stance still further. The pace at which this happens depends on economic developments, and the degree to which this normalisation takes place through higher nominal Central Bank rates will depend on future developments in inflation.

Towards the end of last year and in the past several weeks, the Central Bank has sold foreign currency in the interbank market. The Bank also announced that it had temporarily suspended its programme of weekly foreign currency purchases. These measures were approved at an extraordinary meeting of the Monetary Policy Committee in early January. The intervention measures amount to 7 b.kr., including 4 b.kr. this year. In comparison, the Bank was a net buyer of foreign currency in the amount of 60 b.kr. in 2010-2012, and those foreign currency purchases were made at a considerably lower exchange rate than the recent sales. Furthermore, on 19 February the Bank concluded a forward currency swap agreement with Landsbankinn in the amount of 6 b.kr., which means that Landsbankinn will not need to accumulate foreign currency to comply with the Bank's foreign exchange balance requirements.

The Monetary Policy Committee is of the opinion that intervention of this type is justifiable in order to mitigate temporary exchange rate volatility that is addressed more effectively with instruments other than interest rates. In recent weeks, the foreign exchange market has been characterised by an unusual combination of features: weakening terms of trade, foreign exchange accumulation in anticipation of heavy foreign debt service, foreign exchange mismatches in the banks' balance sheets and, in part, self-fulfilling expectations of a currency depreciation. Because these conditions are in part temporary and increased foreign exchange inflows are expected as the spring advances, limited one-off foreign currency sales by the Central Bank were considered appropriate to prevent excessive currency depreciation and stem the tide of these self-fulfilling expectations of market participants. This is consistent with the strategy outlined in the Bank's report *Monetary Policy After Capital Controls*, published in late 2010.

Capital controls were imposed early in the winter of 2008 as part of the Government's IMF programme. In addition to changes to the expiry date of the controls, major amendments have been made twice: in October 2009, when cross-border transfers of krónur were prohibited and outflows deriving from new investment were liberalised; and in March 2012, when exemptions from the Central Bank of Iceland were required for disbursements from the failed banks.

Parliament has just passed amendments to the Foreign Exchange Act, with broad-based support from its members. The Central Bank participated in drafting this amendment and supports it. The amendment creates a stronger foundation for the work that lies ahead in finding a solution to the settlement of the banks' estates that is consistent with monetary and exchange rate stability and facilitates larger steps in liberalising the controls. The Bank also welcomes the enhanced understanding of the nature of the capital controls and the fact that they are a necessary evil, as is reflected in the consensus on the issue.

The aim of the controls was to arrest the decline of the króna, provide shelter for the restructuring of private sector debt and the financial system as a whole, and create the space for economic policy to mitigate the recession and ultimately support recovery. In broad terms, these goals have been realised. Without the controls, much stricter monetary policy would have been required in the early stages of the crisis. The Treasury would have had much less scope to mitigate the contraction in 2009, as domestic financing of the deficit would have been much more expensive. In this context, it is worth noting that, on average, real interest rates on new domestic Treasury borrowings were negative by almost half a percentage point in 2009-2012.

But these stabilisation gains of the capital controls will diminish over time. The capital controls also have efficiency costs associated with them – costs that were probably modest to start with but increase with time. There is little or no research on how high these costs are at present, and assertions to that effect are not well founded. It is still more difficult to make a quantitative assessment of the risk accompanying liberalisation of the controls, which is presumably greater the faster the controls are lifted and as the economy is less prepared for it. From a theoretical standpoint, we should lift the controls the moment the present value of future efficiency costs exceeds the present value of future stabilisation gains, including the risk accompanying speedy liberalisation. That precise moment can never be identified with any certainty, however, although most signs indicate that it has not come yet, for if it had arrived, rapid liberalisation would be underway. At this point, it is likely that the benefits of lifting the controls more gradually are still greater than the cost of retaining them for a little longer. The pivotal issue here is what tools they give us in order to prevent the settlement of the failed banks from jeopardising financial stability.

But none of this changes the fact that we must lift the controls as soon as it is safe to do so, both because of the economic cost of retaining them and because of Iceland's international obligations. In my speech a year ago, I said that this was one of the most complex tasks facing the Icelandic authorities at the time. That has not changed. A prerequisite for success is that we base our efforts on the best possible analysis of the problem and the potential solutions to it. Until now, the controls have been viewed as providing shelter during the resolution of the balance of payments problems caused by the collapse of the financial system. If all non-residents' potentially volatile claims on residents were paid in a short period of time, Iceland would pay down foreign debt much more rapidly than is desirable. If worse comes to worst, the deleveraging could amount to roughly half Iceland's GDP in relatively few years. Under such circumstances, the króna would depreciate significantly, at least over a considerable period of time, the banks' liquidity would be weakened, and public sector finances would do likewise. Domestic and foreign Treasury financing would be much more difficult and expensive to come by.

But is this analysis correct? Is Iceland faced with a balance of payments and refinancing problem rather than a debt sustainability problem? The difference between the two lies in the fact that a household, firm, national treasury, or nation is facing a debt sustainability problem if cannot service its debt with the available revenue surplus no matter how long the debt is stretched out. Then debt relative to income rises without limits. In that case, there are only three solutions: increased revenue surpluses, reduction of debt, or reduction of interest rates. On the other hand, a payment and refinancing problem exists when a longer loan duration would eliminate temporary debt service shortfalls. But two provisos must be made here. First of all, the boundaries between the two are not always clear. Unlimited loan durations are not available. A sustained refinancing problem can lead to a default and a debt sustainability problem. It can also change into a debt sustainability problem if interest rates rise steeply upon refinancing. Second of all, a nation's debt is different in nature than the debt of an individual. A nation consists of numerous legal entities, and if some of them cannot handle their debt, it need not have severe consequences for other parts of the whole, provided that the sovereign is not involved. Under a flexible exchange rate regime, national debt service in excess of surpluses will also cause the currency to depreciate and the surplus to grow. But this process is not without limits.

Earlier this week, the Central Bank published a report on Iceland's underlying external position, in which it addresses the question of whether Iceland is facing a debt sustainability problem or a balance of payments problem as I have just defined them. But in order to answer that question, it is necessary to peer through the settlement of the estates resulting from the financial crisis – a process that is nowhere near completion – and correct for the effects of certain international corporations operating in this country. These companies have a profound effect on Iceland's international investment position as measured according to international standards, but they would have a negligible impact on the state of the domestic economy if they defaulted on their debt. As a result, the task requires a great deal of estimation and entails some uncertainty, as previous findings have shown. The estimates are now more reliable than before, however, as time has clarified a number of factors concerning the failed banks' estates and analysts have now gained access to the best available data.

The results are the same as in previous appraisals, however, in that there are no signs of a debt sustainability problem as I have just defined it. Iceland's net underlying debt position is estimated at 60% of GDP, the lowest since 1999. Furthermore, it is lower than that of many countries that no one would claim faced a sustainability problem. New Zealand's net debt position, for instance, has hovered around 80% for more than one decade. Based on the outlook for Iceland's underlying trade balance and the prospects for domestic output growth, this would be sufficient to reduce its debt position by 18 percentage points of GDP through 2017. Considering the uncertainties in the estimate, it is likely that the net external debt position lay in the range of 35-80% of GDP at year-end 2012. But the upper end of this range is not enough to create a debt sustainability problem as, even in this case, Iceland's debt will still continue to decline through this period. In addition, it should be noted that this estimate assumes that the current stock of offshore krónur is assessed at the onshore exchange rate and the failed banks' ISK assets are assessed at nearly full book values and at the onshore exchange rate. That will not be the case, of course. In order to gain some perspective on the amounts involved, it is useful to note that each 25% reduction in the valuation following the sale of these assets from the estates and their expatriation from Iceland reduces the measured debt position by a full six percentage points of GDP. The final figure will be much large than this, of course.

Is there no problem, then? Yes, there is. The report shows that the balance of payments problem could become substantial in a very few years if domestic access to foreign capital and refinancing does not improve. It is estimated that there will be a surplus on the underlying current account balance this year – just under 4% of GDP – but this excludes the estates of the failed banks and the effects of pharmaceuticals company Actavis. Iceland could therefore reduce its net external debt by that amount. The problem is, however, that the calculations shown in the Bank's report assume this surplus could contract in coming years and may even turn into a deficit at a time of rising foreign debt service for borrowers without access to foreign refinancing. If these parties do not gain access to the market on acceptable terms in the near future, or if other capital inflows are not forthcoming, significant downward pressure on the Icelandic króna will be inevitable. Weighing heavily in this context is the debt owed by new Landsbankinn to the old bank. Negotiations concerning the possible lengthening of the maturity of this debt are underway.

It is possible to argue that this outlook is based on extremely pessimistic assumptions. Market access has already opened up, as Arion Bank's recent foreign borrowings show. The calculations in the Bank's report assume that foreign interest rates will return to pre-crisis levels in a few years, but there are few signs of this at present. It is also assumed that the import ratio will return to pre-crisis levels. The Central Bank will examine additional scenarios for possible developments in the balance of payments in coming years, and developments in market access in coming months will have a significant effect on the outlook.

In spite of this proviso and the necessity of not presenting unrealistically pessimistic scenarios that could undermine confidence needlessly, this scenario does not go so far, and we must determine what we can do to prevent such an outcome. Economic policy and the structural reforms must ensure that Iceland's competitive position does not deteriorate more than can be expected following a normal rise in the real exchange rate from historically low levels, given that we will have a current account surplus while we are working our way through the bulk of the debt. It is most important that public sector finances be well in surplus during this period and that attempts be made to ensure a higher level of national saving than prevailed in Iceland before the crisis. Furthermore, it is clear that the scope to use the current account surplus to release non-residents' ISK assets will be extremely limited in coming years.

How likely is it, then, that we can lift the capital controls in the next few years? Obviously, it would be much easier if new capital inflows were forthcoming, either through new foreign borrowing or through foreign direct investment. In addition, it is clear that no decisive steps can be taken to lift the controls before a suitable solution is found to the settlement of the failed banks' estates. That solution could take many forms, and these would affect the subsequent approach to lifting the controls. A revised liberalisation strategy would therefore look quite different depending on what route is chosen for the settlement of the failed banks' estates. A solution to this problem must therefore come first.

I won't discuss these possibilities at greater length here, as a great deal of work lies ahead, and it would be unwise to show our hand at this point. Furthermore, it is necessary to have more than one option at hand, in case the one that seems best at the outset proves infeasible later on. It is possible, however, to make a few comments that will enhance the general understanding of what needs to happen. If a portion of the estates are settled through composition agreements, it is of key importance that the ISK asset recoveries add as little as possible (or nothing at all) to the stock of volatile ISK assets owned by non-residents. It is important to bear in mind that selling the banks at a relatively low price to foreign investors interested more in the short term and in handsome dividend payments does not solve the problem and could even exacerbate it.

It is the role of the estates to divest the assets and make payments to creditors. The question is, however, what is a realistic price for the assets, and at what exchange rate will they be converted into foreign currency. That depends on who wants to buy them and is willing and able to bring in the necessary currency, which cannot come from export revenues or the Bank's foreign exchange reserves.

In lifting the capital controls, we are faced with the question of how far we are willing to go. Shall we return to the way things were before the crash? History shows that Iceland has generally done best when it has maintained open business ties with the rest of the world. Iceland is not alone in this regard, of course, as both history and economic theory have shown that international trade generally enhances well-being. This is also true of capital transactions. But it is also a fact that most severe financial crises in small, open economies like Iceland originate, at least in part, in excessively volatile capital flows to and from the country, which foster debt accumulation and asset bubbles during upswings and then shut down the mains during the downward cycle. Unrestricted capital flows are thus coupled not only with benefits but also with risk. This risk can be mitigated with sound economic policy and an appropriate regulatory and supervisory framework, but it will never disappear entirely. Consequently, there are a number of signs that, contrary to generally accepted ideas about free trade in goods and services, financial integration with the outside world can actually go too far. This is supported by studies indicating that there are "thresholds" in terms of benefits from financial integration and that form matters. For instance, foreign direct investment does not usually jeopardise economic stability, while short-term movements and carry trade are riskier.

It can be argued that Iceland had gone too far in financial integration in the years before the financial crisis. In part because of this, the Central Bank recommended, in its 2012 report entitled *Prudential Rules Following Capital Controls*, that before the capital controls are lifted, restrictions should be placed on financial firms' foreign exchange risk and their ability to expand their foreign currency balance sheets with the associated maturity mismatches. Restrictions would also be placed on foreign-denominated borrowing by households, firms, and municipalities without income in the borrowed currencies. These ideas are being developed and honed, and some of them could be implemented with the entry into force of new liquidity and foreign exchange balance rules that the Central Bank intends to issue this year.

It has been said that a reassessment of the monetary policy framework must take place before the capital controls can be lifted in full. This is perhaps not as critical as it might seem, however, as countries with unrestricted capital flows have various kinds of monetary policy framework. Nonetheless, it is necessary to review our monetary policy, and the Bank has published reports on this topic in the recent term, one entitled *Monetary Policy After Capital Controls* and the other entitled *Iceland's Currency and Exchange Rate Policy Options*. In addition, there could be a number of policy formulation tasks ahead for the Central Bank which are beyond the scope of my speech today, such as financial system structure – including questions on the extent to which further restrictions should be placed on maturity mismatches in financial institutions' balance sheets and how the system's public goods elements can be protected against leveraged speculation.

Honoured guests: In closing, I would like to thank the Central Bank's many collaborators for a successful co-operative relationship over the past year. First among them are the ministries with which the Bank works most closely – in particular, the Ministry of Finance and Economic Affairs, which now is responsible within the ministries for the affairs of the Central Bank. In this context, I wish to thank the two Ministers who have led the Ministry of Finance and Economic Affairs since this arrangement was introduced. I would also like to thank the Parliament of Iceland, particularly the Economics and Commerce Committee, for their cooperation during the year. Thanks are due as well to the Financial Supervisory Authority for growing collaborative relationship. I thank the outgoing Supervisory Council for good cooperation. And last, but certainly not least, I would like to thank the staff of the Central Bank for their hard work and excellent contribution during the year.