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Speech

Már Gudmundsson, Governor of the Central Bank,
delivered at the 57th Annual Meeting of the Central Bank of Iceland, 5 April 2018.

Mr. President; Prime Minister, other Ministers, Speaker of Parliament, Directors and Ambassadors; Ladies and Gentlemen!

The Icelandic economy has been in fine fettle recently, with full employment, to say the least, as we have had to import a large number of workers to support economic activity. The risk of overheating has receded somewhat in the past year, however; the positive output gap has narrowed, and the residential housing market is less stretched than it was a year ago.

Until last month, inflation had been close to target but below it for four years running. Inflation expectations have been at target by most measures in the recent past. It is this that has enabled the Bank to lower its policy interest rate by 0.75 percentage points since our last Annual General Meeting. Inflation expectations have fallen to the target and have become more firmly anchored there, reflecting the success of monetary policy in the recent term. The Bank's Chief Economist recently published a Working Paper explaining this success, noting as well that the decline in inflation to the target between 2012 and early 2014 was virtually costless, partly because of increased credibility of monetary policy.[1] If changes are made to the monetary policy framework in the coming term, it is important to preserve this success.

One of the main reasons for reduced demand pressures in the economy is that GDP growth has subsided after peaking in 2016 and is now approaching its long-term trend rate. The slowdown in GDP growth reflects weaker export growth, as the tourism boom cannot be expected to continue at the pace seen in the recent past. Furthermore, the improvement in terms of trade has slowed down considerably. This means that the effects of the positive shocks that enabled us to grow rapidly and simultaneously keep inflation low are tapering off. The appreciation of the króna played a major role in the economy's adjustment to these shocks. However, the Bank intervened in the foreign exchange market and imposed a special reserve requirement (SRR) on capital inflows to prevent the

[1] Thórarinn G. Pétursson (2018), „Disinflation and improved anchoring of long-term inflation expectations: The Icelandic experience", Central Bank of Iceland *Working Paper* no. 77. This improved performance of monetary policy is also discussed in detail in Central Bank *Special Publication* no. 11, entitled "Monetary policy based on inflation targeting: experience since 2001 and post-crisis changes". See: www.sedlabanki.is

króna from overshooting. Now, however, a significant additional rise in the real exchange rate would be risky.

Interest rates in Iceland are currently low in historical context, particularly in view of the business cycle position. With one short-lived exception, indexed Treasury bond rates have never been lower, and indexed mortgage lending rates are also at a historical low. Apart from a short period early in this decade, when Iceland was at an entirely different point in the business cycle than it is now, the Central Bank's interest rates are at their lowest since the early 1990s, when they became an important monetary policy instrument. We must therefore consider realistically whether we can expect further reduction of interest rates without an outright slack in the economy. Developments in Central Bank rates over the coming term will be determined by economic developments, which could be in either direction.

When we met a year ago for the Bank's Annual Meeting, the vast majority of the capital controls had just been lifted. As expected, exchange rate volatility increased afterwards. But that volatility proved temporary, and short-term fluctuations in the exchange rate subsided markedly in the latter half of the year. In recent months, short-term volatility has actually been limited in historical and international context. The Central Bank has not intervened in the foreign exchange market in recent months, supporting the conclusion that this reduced volatility is due to improved balance in capital flows.

According to currently available forecasts, GDP growth is set to remain robust and the domestic economy will experience a "soft" landing. The outlook is uncertain, however, and various risks could materialise, not only in Iceland but also abroad, where uncertainty is considerable at present. In addition, it is important that there is considerable scope for interest rates and large foreign exchange reserves to respond to adverse developments. The longer long-term inflation expectations are anchored to the target, the greater that scope will be. One of the main tasks of monetary policy, of course, is to foster such an outcome. However, if other decisions that affect domestic cost levels and demand pull in another direction, such a tug-of-war could result in a further rise in the real exchange rate and could adversely affect employment levels.

Honoured guests: Although nearly all of the capital controls were lifted in March 2017, a few restrictions on capital transfers remain: on the one hand, restrictions on offshore krónur, and on the other, restrictions on speculative derivatives transactions involving the króna and other transactions that could undermine the efficacy of the SRR.

In order to be released from the current exemptions provided for in international agreements on free movement of capital, vis-à-vis both the EEA and the OECD, we must lift these restrictions, and it is appropriate that we aim to do so as soon as possible. The Central Bank is of the view that the economic preconditions are in place to take the final step towards full capital account liberalisation. This also applies to the stock of offshore krónur, which now equals about 3½% of GDP,

down from 40% in late 2008, when the capital controls were first imposed. But this cannot be done without statutory amendment.

The Bank does not consider it appropriate yet to begin lowering the SRR. The interest rate differential with abroad is still too wide, although it has narrowed considerably since the SRR was imposed in June 2016. Given how high the real exchange rate is, this is not a good time to take the risk of pushing it higher than economic fundamentals warrant. If forecasts materialise, the conditions for lowering the SRR will improve in the coming term, as Iceland's positive output gap is projected to keep narrowing and global interest rates are expected to rise.

When the SRR was introduced, there were still broad-based restrictions on capital outflows. The SRR was justified in part with reference to the liberalisation process, and there were concerns that the offshore krónur that exited via the Bank's June 2016 auction would re-enter immediately in search of a new carry trade opportunity. It is surely counterproductive to open the gates for large-scale carry trade before the carry trade positions from the last spree have been closed out. On the other hand, there will be grounds to revisit the level of the SRR and the asset classes affected by it when the final capital account liberalisation measures are taken.

The Bank's large international reserves, which have been financed domestically for the most part, are the result of the strategy of building up large enough reserves to reduce the risks associated with capital account liberalisation, and of the positive shocks that made it possible to build up the reserves without foreign borrowing. That build-up took place over a very short period in 2014-2016, when foreign currency inflows were at a peak.

In my speech at last year's Annual Meeting, I outlined the benefits of maintaining the reserves — benefits enjoyed by many — and I also discussed the costs, which fall mainly on the Central Bank. These costs derive from a negative interest rate differential, as the reserves are currently invested abroad at low interest rates, while the rates on the Bank's króna-denominated debt are much higher. Extrapolations carried out last year indicated that because of this, the Bank's operating results would be negative by roughly 18 b.kr. per year. New calculations indicate that this loss has shrunk to 15 b.kr. per year, mainly because the international reserves are smaller and the interest rate spread is narrower.

Central banks do not become insolvent in the conventional sense, even if they have negative equity; indeed, many respected central banks have operated under such conditions for longer or shorter periods. This is because the purchasing power of the reserves is intact as regards the purpose they serve, and central banks themselves issue the currency they use to pay domestic costs. Even so, it could be detrimental if the Central Bank of Iceland has significantly negative equity, as this could undermine its independence and its ability to achieve the price stability objective. In the near future, a number of actions will be taken to improve the Bank's financial outcome, including through having the commercial banks participate indirectly in covering the costs of the reserves. It could also

come to pass that the Bank will call in a portion of the callable equity provided for by law.

Honoured guests: We have made significant strides in rebuilding the banking system and placing it on a stronger footing than before the financial crisis. The banks focus primarily on providing services to domestic households and businesses. They are much more resilient now than they were before. Their capital ratios are well above the thresholds set by the Financial Supervisory Authority — thresholds that are much higher than before the crisis. Their liquidity position is good as well. The same can be said of borrowers, whose position has improved radically.

These improvements in the banking system's position play a major part in the Financial Stability Council's conclusion at recent meetings that there are few risks to financial system stability at present. Nevertheless, the Council has pointed out some risk factors.

One of them is the high price of residential and commercial real estate, which could, in combination with low interest rates and ample collateral capacity, lead to a strong increase in indebtedness, with the associated risk of a setback followed by increased loan losses. To a degree, the authorities have responded to this risk: last year the Financial Supervisory Authority imposed a ceiling on residential loan-to-value ratios, following analysis and discussion within the Systemic Risk Committee, which works for the Financial Stability Council, and upon receiving an opinion from the Council. Developments in the real estate market will continue to be monitored closely in this respect, and the possibility of applying additional macroprudential tools will be considered.

Another risk factor that the Financial Stability Council has identified is uncertainty about future developments in the tourism sector and the potential impact that a setback in the industry would have on the position of the banking system. At the end of 2017, lending to the tourism sector accounted for 9% of the large commercial banks' total lending, but because growth in tourism has eased recently, this ratio has held broadly steady. The Central Bank of Iceland conducts an annual stress test in consultation with the Financial Supervisory Authority, in which it examines the impact of macroeconomic scenarios on the commercial banks' resilience. The results are published in the autumn issue of the Bank's Financial Stability report. The last stress test assumed that there would be a recession in trading partner countries, plus a drop in major export prices and a steep decline in the number of tourists visiting Iceland. In this scenario, the banks' capital ratios would fall by an average of 3½ percentage points, to a level close to the minimum capital ratios currently required by the Financial Supervisory Authority.

These two risks could easily occur in tandem, however. According to a new working paper by two Central Bank staff members, growth in private property rentals to tourists via Airbnb has increased real house prices by 2% per year in the past three years; furthermore, it explains about 15% of the rise in real prices

over this period.[2] A contraction in tourism could therefore exacerbate a drop in house prices stemming from other causes. The impact on the banking system would then be greater. It is nevertheless unlikely that they would be unable to withstand such a turn of events, but they would probably need to use the capital buffers that are designed to cushion against such shocks.

That gives rise to the question of how high the banks' capital ratios should be. Their combined capital, including subordinated loans, was equivalent to 25% of the risk-weighted asset base of the three systemically important banks at the end of 2017, and their so-called gearing ratio was just under 17%. The gearing ratio measures net equity relative to total assets without risk adjustment. Approved dividend payments will lower the capital ratio to 23½% and the gearing ratio to just under 16%. These figures can be expected to fall even further during the year, owing to dividend payments and changes in the composition of capital. The ratios are certainly comfortably above the Financial Supervisory Authority's capital adequacy requirements, which are close to 20% for the three commercial banks. They are also well above the levels generally seen in neighbouring countries. For example, European banks of a size similar to Iceland's banks have capital ratios of just over 18% and gearing ratios of about 8%. Elsewhere in the world, capital ratios are higher than those in Europe in some cases. Furthermore, many observers consider the actual capital in the European banking system is too limited and that Europe is therefore not the best reference for Icelandic banks. Nonetheless, there is some scope to lower the banks' capital ratios — and gearing ratios in particular — with dividend payments and changes in the composition of capital. On the other hand, the banks are being cautious in maintaining a so-called "management premium" over and above the Financial Supervisory Authority's minimum requirement, as it could erode confidence in the banks if their capital ratios fall below the minimum were they to face only mild headwinds. Moreover, the banks must bear in mind that the countercyclical capital buffer is currently 1.25%, but the Financial Stability Council has signalled that it could increase it in stages to 2.5% as the financial cycle gets more wind in its sails.

In assessing a desirable level for the banks' capital, it is important to remain aware of the costs and benefits. At times, international discussion of this topic has been somewhat misleading and, to some extent, affected by bank executives' interest in maximising their own remuneration through risk-taking, knowing that a portion of possible losses would be absorbed by taxpayers. Capital is not dead money, as is sometimes implied. It is available for disposal in order to finance the assets side of the balance sheet, including lending. Furthermore, there is no universal principle that says banks with more capital have less lending capacity; in fact, research has confirmed that banks with stronger capital had an easier time obtaining funding during and after the financial crisis, and they reduced their lending to customers less than other did — aside from merely surviving.

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[2] Lúdvík Elíasson and Önundur Páll Ragnarsson (2018) "Short-term renting of residential apartments, Effects of Airbnb in the Icelandic housing market", Central Bank of Iceland *Working Paper* no. 76. See: www.sedlabanki.is

Most companies need equity, as banks and other lenders are usually reluctant to grant loans to companies without it. But where banks are concerned, other factors are involved. Banks receive sight deposits, which are a part of payment intermediation in any country, but at the same time they are long-term investors on the assets side, with the associated risk of a run that could render them unable to honour their obligations. Such runs on banks are often connected to uncertainty about the banks' capital. This is where central banks come in as liquidity providers and lenders of last resort, in addition to deposit insurance and other contingency measures that are part of the official safety net for the banking system. But the safety net creates a moral hazard that entails taking excessive risk at taxpayers' expense. This is where the regulatory framework enters in: to place limits on risk and to set capital requirements so as to reduce the likelihood of a run on the banks, leaving taxpayers to pay the bill. How high the requirements must be is always a balancing act, as it is hardly possible — and actually undesirable — to set them high enough to render the banks bullet-proof.

We must not allow the banks' current resilience to blind us to the great challenges facing them. These challenges centre, among other things, on rapid technological advances, increased competition with other financial institutions and companies that offer payment services and loans, increased regulatory burdens, high cost levels, operational risk, cybersecurity threats, and ownership issues. Of course, it is the task of the banks themselves and their owners to take on these challenges, which — as always — represent both threats and opportunities. But the legislature and supervisory institutions also have a part to play. The regulatory burden should not be any more stringent than is needed to limit risk at any given time. Simultaneously, it must be ensured that the regulatory framework extends to all financial market service providers that could contribute to the creation of systemic risk. Maintaining effective consumer protection is important as well; otherwise, there is the risk that justified dissatisfaction will develop — dissatisfaction that will ultimately erode confidence in all financial institutions. In this context, one important issue that calls for supervisory involvement is the boundary lines between financial institutions' cooperation on infrastructure and security, on the one hand, and competition concerning front-line services, on the other. Studies have shown that Icelandic banks cooperate considerably less on security and infrastructure than, for instance, banks in the Nordic countries. In the recent past, the Competition Authority, the Financial Supervisory Authority, the Central Bank, and the banks have worked together to develop a shared understanding on these matters, thereby laying a strong foundation for further cooperation. An example of this is the recent establishment of a temporary cooperative forum on operational security of financial infrastructure, including representatives from the banks, the Icelandic Banks' Data Centre, the Financial Supervisory Authority, and the Central Bank.

The financial system is more than banks; it encompasses financial institutions, financial market infrastructure, and financial markets themselves. Systemic risk can accumulate in all of these and is sometimes amplified by interactions among them. A detailed discussion of these functions is beyond the scope of our meeting

today, but I would like to emphasise that the Financial Supervisory Authority and the Central Bank monitor risk in all of these areas and review it in depth at meetings of the Systemic Risk Committee and the Financial Stability Council. Nevertheless, I cannot leave the topic of the financial system without mentioning the massive overhaul of financial market infrastructure that is currently underway and the germination of ideas in the area of payment intermediation, as the Central Bank is integrally involved with both.

The renewal of the most important core infrastructure elements used for decades to operate the financial system began recently. The investment as a whole represents the financial system's largest IT investment ever undertaken. The overhaul will move us away from "home-grown" solutions to standardised international systems. The systems being renewed are the banks' internal payment systems, the Central Bank's interbank payment systems, and the Nasdaq securities depository's securities settlement system.

A variety of benefits accompany new financial market infrastructure, but the implementation process can be risky, partly because the new systems must communicate with the old ones during the transition phase. Supervisory bodies monitor this risk. It is analysed at meetings of the Systemic Risk Committee and is identified as a risk factor in statements issued by the Financial Stability Council. Such a risk materialised to an extent last November and the cooperative forum on operational security of financial market infrastructure that I just mentioned was set up afterwards. In that forum and elsewhere, work will be done to minimise the operational risk accompanying the ongoing renewal process.

At the same time as the renewal of core financial market infrastructure is underway, a great deal is happening in the field of payment intermediation, both internationally and here in Iceland, owing to new technological solutions and changes in the regulatory framework that will stimulate competition in this area. Among the topics under consideration is the new EU Payment Services Directive, which is to be implemented in Iceland in the near future. In addition, virtual currencies have come into use as a medium of payment, both nationally and across borders, and there is a great deal of discussion at present of the pros and cons of central bank issuance of electronic money.

In view of the many changes currently underway in the field of payment intermediation, the Central Bank has previously discussed the necessity of establishing a permanent information and cooperation forum representing all stakeholders in this area. In the near future, the Bank will take the initiative on this, with the aim of establishing the forum before the end of this year.

Apart from its Financial Market Infrastructure report, issued in June, the Bank is planning to publish two reports on these topics quite soon. One is a report on retail payment intermediation from the standpoint of preparedness and financial stability, which focuses on debit card use, real-time settlement, and the importance of effective electronic payment intermediation in Iceland, both in

favourable and unfavourable conditions. The other report focuses on the possible issuance of electronic krónur.

I don’t want to reveal too much now, but there are a few points worth considering in this context. First of all is the importance of real-time settlement, which enhances efficacy and security. This has been a feature of payment intermediation in Iceland for a decade and a half, and it is where other countries are heading. It is therefore vital that we preserve that feature during the changes now taking place. Second, it is important to keep the cost of domestic payment intermediation down. New and more diverse solutions that, for example, work directly with core financial market infrastructure, such as bank deposits and the Icelandic Banks' Data Centre’s systems, could help in this regard. Third, it is important that it be impossible to stop domestic payment intermediation through some sort of foreign intervention. Fourth, there must be alternate routes in the system, in case anything goes wrong. This could call for some diversity in payment intermediation, using different types of technology. Electronic krónur could play a role in this. But the topic of electronic krónur gives rise to big questions that must be discussed — questions about the possibilities for the general public to use electronic claims against the Central Bank (and indirectly against the State) as a medium of payment instead of bank deposits, and questions about the repercussions this could have on the role and stability of the banking system. The discussion promises to be an interesting one, and it is just beginning.

In closing, I would like to thank the Supervisory Board and the Monetary Policy Committee for their work over the past year, and I wish to thank the Central Bank’s many colleagues and collaborators for their cooperation – not least the Prime Minister’s Office, the Ministry of Finance and Economic Affairs, and the Financial Supervisory Authority. I would also like to thank the financial institutions with which the Bank interacts for their cooperation. Furthermore, I would like to thank the Parliament of Iceland, particularly the Economics and Commerce Committee, for their collaboration. And last but certainly not least, I want to thank the staff of the Central Bank for a job well done over the past year.