27 March 2014

Speech

Már Guðmundsson, Governor of the Central Bank
delivered at the 53rd Annual General Meeting of the Central Bank of Iceland, 27 March 2014

Mr. President, Prime Minister, Minister of Finance and Economic Affairs, Chairman of the Supervisory Board, former Governors, Directors, Ambassadors, Ladies and Gentlemen:

This Annual General Meeting is the Bank's sixth one since a large part of the Icelandic financial system collapsed, ushering in the deepest economic contraction Iceland has seen since measurements began after World War II. It is also the last Annual General Meeting in my current term as Governor. For this reason, and because we stand at a turning point in the resurrection of Iceland's economy and financial system, it is appropriate to look back, assess the progress made, and identify the challenges ahead.

Iceland's financial crisis was part of the global crisis that peaked in September 2008, when the US investment bank Lehman Brothers failed, triggering a worldwide run on banks' foreign funding. Had it not been for the coordinated response by leading central banks around the world, which provided collateralised US dollar liquidity to international banks, both directly and through foreign currency swaps, many of those banks would have gone under.

Iceland was a participant in this cooperative effort only to a very limited degree. But its commercial banks were highly dependent on foreign funding, which was much shorter-term than the foreign assets in which they had invested. On its own, the Icelandic Government was in no position to provide Icelandic banks with the FX liquidity facilities that their foreign counterparts were receiving at the time, and it would have placed itself in real peril had it tried to provide them with enough assistance to prevent them from defaulting on their FX liabilities. In addition, there were a number of other weaknesses in their balance sheets – weaknesses that would probably have posed serious problems for them in any case, albeit later on.

But even though the situation developed as it did in Iceland, it is important for us to remember that it was this coordinated international response that prevented the financial crisis on both sides of the Atlantic from mushrooming into a tidal wave of national and international bank failures. And it was this response that kept the economic recession from developing into a full-blown depression like that in the 1930s. Central banks played a key role initially, providing massive liquidity facilities and coordinated monetary easing on the home front and, not least, negotiating FX swaps that actually entailed a global extension of the US Federal Reserve's role as lender of last resort.

In addition to mitigating the imminent contraction, these measures were an attempt to interrupt the vicious cycle of fire sales of illiquid assets, falling asset prices, and evaporating liquidity, thus reducing the risk that banks' equity would plunge below regulatory minimums and banks around the world would start falling like dominoes. Such a turn of events would have had severe effects on the real economy. In this respect, it is important to refrain from drawing too-sweeping conclusions from the banking collapse in Iceland, as the international part of Iceland's banking system was so large and domestic banking operations were actually kept up and running at considerable cost.

International cooperation on crisis management grew markedly in scope, particularly through collaboration among the G20 countries and at the International Monetary Fund. It encompassed a common perspective on fiscal measures to support the banking system and stimulate demand, and the provision of support to specific countries. Later on, emphasis shifted to the reform of the financial regulatory framework. That work is still underway.

But in spite of these measures, by late 2008 and early 2009 the recession on both sides of the Atlantic had become the deepest since the interwar years, and on a global level it was the most extensive and synchronised contraction in history. All of this affected the Icelandic economy, of course, but added to it were the collapse of Iceland's banks, the plunge in asset prices, and the inevitable adjustment of domestic demand following the overheating in 2005-2007 – an adjustment that had begun before the banks fell. The contraction from the peak in Q4/2007 to the trough in Q1/2010 was the deepest Iceland has seen, at least in the post-war period. GDP contracted by nearly 12½%. In this context, we must remember, though, that the peak was utterly unsustainable, combining as it did a wide positive output gap and an enormous current account deficit.

Iceland's economic recovery began in Q2/2010. We are well on our way towards recouping our lost GDP, and forecasts indicate that this year we will have recovered it in full. The difference, though, is that the domestic economy is in much better balance than it was then. We are running a current account surplus, and inflation is on target. One might ask how much of a success this actually is, given that a number of other countries have already recovered their lost output. It has been pointed out that Iceland's investment level is low, but this has been true of most developed countries recently, apart from major commodity producers such as Australia, Canada, and Norway. If we compare Iceland's recovery to the experience of other countries that have suffered a twin banking and currency crisis, we see that it is far from anomalous, not least in view of the fact that, among comparison countries, recoveries have often taken place in a much more favourable global economic environment than we are facing today.

In assessing the recovery, it must also be borne in mind that the room for manoeuvre for stimulating demand was limited. From 2010 onwards, fiscal policy had to focus on gradually eliminating the fiscal deficit, which was a prerequisite for reinstating the sovereign's access to foreign capital markets. Early on, the Monetary Policy Committee had to focus on stabilising the exchange rate in order to stop the collapse of asset prices and the automatic increase in private sector debt, most of which was either exchange rate-linked or indexed to the CPI. The scope to cut interest rates in order to stimulate demand was therefore limited, although it began to develop over the course of 2009. The capital controls that were introduced in late 2008 provided some room for manoeuvre and enabled the Central Bank to allow real interest rates to fall faster than would otherwise have been possible. Inflation, which had skyrocketed after the currency collapsed, began to subside gradually, but the inflation spike caused by contractual wage increases and excessively high inflation expectations cut into that room for manoeuvre from mid-2011 onwards.

In order to understand the economic recovery in the face of these headwinds, two points are important. The first point centres on the nature of the recession. To some extent, the recession represented the inevitable adjustment of domestic demand to the fact that it was no longer possible to fund the country's massive current account deficit and to the abrupt contraction of two sectors – financial services and construction – that had grown exponentially during the upswing. When the dust settled, the domestic economy still rested on other sturdy foundations, and the low real exchange rate stimulated some of Iceland's tradable sectors. The second point is that Iceland is a small, open economy, where domestic demand is often less of a driver of GDP growth than foreign demand than is the case in much larger economies. There is a tendency in Iceland to forget this in discussions of economic policy.

Honoured guests: We are at a turning point with respect to monetary policy implementation. For most of last year, inflation and inflation expectations were well above the inflation target, and the economic recovery was gaining momentum, while inflation forecasts suggested that it would remain above target for a sustained period, provided that the exchange rate remained close to the level prevailing at the time. It would have been possible to conclude from this that the monetary stance was too loose. Actually, several critics maintained that the monetary stance was too tight, but economic developments have shown no signs to support that argument, nor is it consistent with common measures of the appropriate stance of monetary policy. The Monetary Policy Committee considered the monetary stance sufficient to bring inflation back to target in the near future.

In February, we were gratified to see inflation subside to target for the first time since early 2011. As far as monetary policy is concerned, there are three factors that have contributed to this achievement. The first is the interest rate hikes between August 2011 and November 2012, a response to the foreseeable inflation spike following the spring 2011 wage settlements. Although controversial at the time, these rate hikes have proven their value in containing inflation without derailing the economic recovery. Second, the Monetary Policy Committee's warning – that the same would happen this year if wage increases should prove excessive – appears to have been credible, which probably would not have happened without the previous rate increases. Third, the foreign exchange market intervention policy introduced by the Bank in mid-May has proven effective.

The outlook is for inflation to stay close to target this year if the króna holds relatively stable. This positive outlook is due to a number of factors: favourable inflation developments during the first two months of the year, signs that wage cost increases have been smaller in the recent term than previously thought, the fact that the recent wage settlements – which provided for pay increases consistent with the inflation target – appear to have set the tone for subsequent wage negotiations, and the fact that global inflation looks set to be somewhat lower than previously forecast.

Looking beyond this year, however, inflation could rise again when the slack in the economy disappears and the effects of increased investment and the Government's debt relief measures on domestic demand come to the fore. The impact this has on inflation will depend on how inflation and inflation expectations develop this year, and on other factors that could affect demand in the near term. It will be the Monetary Policy Committee's task to decide how to respond to these different short- and long-term prospects, with the aim of keeping inflation close to target.

Monetary policy instruments are currently being revised, with an eye to improving liquidity management and preparing for a tightening of banking system liquidity concurrent with the Central Bank of Iceland Holding Company's domestic asset sales and other possible measures related to capital account liberalisation, which will cause short-term market rates to move closer to the centre of the Bank's interest rate corridor. This could increase the Bank's net interest income.

The monetary policy currently being pursued is different than that prevailing before the crisis, owing to the presence of the capital controls and a managed float rather than the virtually free-floating exchange rate regime that was in place before the crisis struck. The policy described in the Bank's December 2010 report "Monetary Policy in Iceland After Capital Controls" has therefore been implemented in part. It is possible that we could go even further in the near future and create a monetary policy framework that would supplant the joint declaration of March 2001, confirming some of the changes already in place and paving the way for others. If that is done, it is important to remember that there are limits to what monetary policy can achieve. In the long run, monetary policy can affect inflation, and in the short run it can smooth out cyclical fluctuations, particularly when it is credible; i.e., if inflation expectations remain close to target even during attempts to mitigate recessions.

Once the slack disappears, however, monetary policy cannot deliver output growth beyond the growth potential of the economy, and any attempts to do so will ultimately lead to inflation persistently above target.

By law, the Central Bank of Iceland has two main objectives. The first is to promote price stability, the main task of monetary policy. The second is to promote financial stability. As regards monetary policy implementation, the Central Bank is independent and stands alone. It is also independent as regards its contribution to financial stability; that is, its own analysis and decisions on the prudential rules it is tasked with setting; i.e., concerning liquidity and foreign exchange risk. In addition, like other central banks, it plays a key role in crisis management through its liquidity facilities and its role as lender of last resort. But it is emphatically not alone in this regard, as there are other bodies that make important contributions – the Financial Supervisory Authority in particular, but also the relevant ministries. The legislature also plays a larger role here than in monetary policy, as the statutory framework for monetary policy seldom changes, while amendments to financial system legislation are much more frequent. As a result, financial stability is more of a collaborative task undertaken by various administrative bodies.

The division of tasks in the area of financial stability varies from one country to another, but in the wake of the recent financial crisis, there has been a shift in attitude towards that division. Before the crisis, there was the tendency to believe that financial and monetary stability were well enough served if monetary policy focused solely on the inflation target, with interest rates as its primary tool, and if financial supervision and the regulatory framework aimed primarily at ensuring that individual financial institutions were sound. The market would then take care of the rest. Experience has shown that this view was too narrow, and in many places it is being abandoned.

To a degree, this entailed a compartmentalisation of central banks' previous tasks. Some countries – the UK, for instance – are addressing this problem by reverting to central banks with a wide-ranging role covering monetary and financial stability. But this is not the only viable response. Here in Iceland, the Financial Supervisory Authority and the Central Bank have stepped up their collaboration on systemic risk analysis and exchange of information. These efforts have borne fruit, and the collaboration between the two institutions is good, but it would be imprudent to let success rest mainly in willingness to cooperate, which could change with a change of actors. As a result, it is important to strengthen the statutory framework so that it can provide better support for these efforts. This is why I welcome the introduction of a legislative bill on a financial stability council, which aims to provide a stronger foundation for systemic risk analysis and response and to guarantee access to the necessary information. Time will tell whether further steps are necessary.

On 9 April, the Central Bank will publish its annual *Financial Stability report*, including a detailed analysis of the financial system and the risks affecting it. I will therefore be brief on that topic. The big picture is this: since Iceland's outward-oriented banking system collapsed, a great deal has been achieved in terms of building up a financial system with a domestic focus. The banks' balance sheets have grown stronger, non-performing loans are on the decline, foreign exchange mismatches have been reduced, equity has increased, and liquidity is strong. Corporate and household debt levels are falling. The regulatory framework for banking operations has also been improved based on the experience gained from the financial crisis, both with implementation of international rules deriving from the important cross-border collaboration that developed during the crisis, and with implementation of rules based more Iceland-specific risk. A good example of this is the new liquidity rules adopted by the Central Bank in December, which are based on the Basel III principles but include special ratios for foreign-denominated liquidity. There are a number of tasks ahead, however, as regards the implementation of rules such as the Basel III capital adequacy rules and special prudential rules that are to be adopted before the capital controls are lifted, so as to address foreign exchange risk and volatile capital movements more effectively.

An effective financial system is an important ingredient of economic progress. It is therefore important to ensure that the regulatory framework does not impede the system's effectiveness unduly. Regulatory provisions may not go further than is needed to safeguard against actual risk. This is why accurate risk analysis is so important. For this reason, among others, the Bank has emphasised working effectively with financial institutions on drafting rules.

The capital controls and their removal remain the most important risk to financial stability in Iceland. The Bank has presented an in-depth analysis of the problem we face, and updated figures related to it will be included in the upcoming issue of *Financial Stability*. The big picture has changed little in the recent term, however. Iceland is facing a balance of payments crisis and this is the main reason for the capital controls. It means that borrowers other than the sovereign and the Central Bank have limited access to foreign capital markets. At the same time, the foreseeable current account surplus over the next several years will not be large enough to cover contractual foreign debt repayments, other things being equal. Furthermore, volatile ISK assets held by non-residents currently total perhaps a fifth of GDP and could rise to almost half of GDP if the failed banks' ISK assets are recovered in full and paid out to creditors. Iceland has no excess foreign exchange revenues with which to unwind these ISK positions, however.

The solution lies in spreading out repayments of foreign loans, solving the ISK problem related to the settlement of the failed banks' estates in a manner that does not exacerbate the balance of payments problem, and opening up market access to resident entities. A number of possible scenarios that could achieve this are under scrutiny at this time, but there is no need to discuss them in detail here. But if such measures generate the results we are aiming at, it is important to ensure that the impact on foreign debt service, whether in domestic or foreign currency, is manageable; to safeguard Iceland's public debt position, sovereign credit ratings, and access to capital markets; and ultimately, to provide domestic entities with access to foreign credit on acceptable terms. Some of these goals may conflict with one another, and this should be considered when a course of action is chosen. In addition, it is important that economic policy and incentives of public systems promote national saving and that attempts be made to safeguard the current account surplus in the years to come, as this will expedite the resolution of the balance of payments crisis, enhance confidence in Iceland, and reduce the likelihood that Iceland will emerge from the process facing economic imbalances. Because these are irrevocable actions, we have only one chance to settle the estates, not a general lifting of the controls, and therefore it is critical that we do it successfully. But as I have said before, that does not change the fact that the cost of the capital controls rises over time and that it is important for progress and high-quality GDP growth that they be lifted sooner rather than later. It is also important that we learn, from our experience and others', that unrestricted capital flows are accompanied not only by benefits but also by risks. Appropriate prudential rules and other measures must be in place to address those risks when that step is taken.

This speech has centred primarily on two of the Central Bank's main tasks: monetary policy and financial stability. But the Bank's functions are actually much broader than this. And many of those functions have grown in scope in the wake of the financial crisis – for instance, the investment and management of larger foreign exchange reserves and a dramatically increased need for legal services. Still other tasks have been added on, such as capital controls surveillance and the recovery of claims that reverted to the Bank after the crash. The Central Bank has gained strength as an institution in recent years, as it has grappled with older projects and newer challenges. In order to deal with them successfully, it has been necessary to expand our staff, but nowhere near as much as one might expect or as much as might have been done in other countries. We have been able to contain our staff levels because we have an exceptional team of highly qualified employees. If the Central Bank is to succeed in its role of safeguarding monetary and financial stability, it is of key importance in the changes that may lie ahead for the Bank that it remain professionally strong and productive. A competent and dedicated staff is vital in this regard. I wish to thank the Bank's employees for their excellent work in recent years.

Honoured guests: In closing, I would like to thank the Central Bank's many collaborators for a successful cooperative relationship over the past year. First among them are the Financial Supervisory Authority and the ministries with which the Bank works most closely – in particular, the Ministry of Finance and Economic Affairs, which now administers the affairs of the Central Bank on behalf of the Government. I would also like to thank the financial institutions with which the Bank interacts for their cooperation. And finally, I would also like to thank the Parliament of Iceland, particularly the Economic Affairs and Trade Committee, for their collaboration.