Address by Ólafur G. Einarsson, Chairman of the Supervisory Board, Central Bank of Iceland, at the Bank's Annual Meeting, March 23, 2004

Prime Minister, Honourable Ministers of the Government, Speaker of the Althingi, Ladies and Gentlemen:

On behalf of the Supervisory Board of the Central Bank of Iceland I welcome you all to the Bank's 43rd annual meeting and declare this meeting open. At the end of my address the Chairman of the Board of Governors, Birgir Ísleifur Gunnarsson, will present a survey of economic and monetary developments, the Bank's monetary policy and its implementation, and the outlook ahead. After his report the Prime Minister of Iceland, Davíð Oddsson, will address the meeting. A reception will be held when the meeting has completed its duties.

At a meeting of the Supervisory Board today the Prime Minister ratified the Bank's financial accounts for 2003 with his signature.

Three years have now passed since the monetary policy framework in Iceland was changed and an inflation target and new legislation were set for the Central Bank. This made the Bank's role more complex and imposed greater demands on it. I feel I can rightly claim that the Bank has lived up to this responsibility and that its monetary policy has delivered the results that had been hoped for. Financial stability was also included in the Bank's remit. One way in which it performs this duty is by monitoring the position of financial institutions and financial system. Findings of regular studies are published in the Central Bank's quarterly *Peningamál*[1]. The new legislation also made demands towards the Bank regarding transparency and accountability to the government and general public. These are fulfilled with dynamic publishing activities and presentation of information on its website, among other things. It was recently announced that, beginning this year, the Bank will publish its quarterly *Peningamál* [in Icelandic] on its website one month later than hitherto, i.e. in March, June, September and December. The Bank will also publish comprehensive macroeconomic and inflation forecasts twice a year, i.e. in June and December, with analyses of economic and monetary developments in the other issues, together with updated forecasts when the

[1] The English version, *Monetary Bulletin,* is published simultaneously in part.

circumstances warrant it. To some extent the new publication schedule is modelled on those of many other central banks with comparable inflation-targeting frameworks. Studies of financial stability will be included in the March and September issues.

As I mentioned, the Prime Minister today ratified the Central Bank's financial accounts for 2003. The Central Bank's financial position changed sharply during the year. Both assets and liabilities shrank and the composition of the balance sheet altered significantly. Total assets amounted to 117 b.kr. at the end of 2002 but decreased by one-quarter during 2003 to 87 b.kr. at the end of the year. The main reason was the greatly reduced requirement of deposit money banks and other financial institutions for Central Bank facilities in the form of repurchase agreements, primarily due to the effect that Central Bank currency purchases and a reduction in the minimum reserve requirement had on their liquidity. Through its currency purchases in the domestic interbank market, the Central Bank was able to repay all its foreign short-term debt during the year, in addition to increasing its foreign reserves by 21 b.kr. Indeed, the aim behind the Bank's currency purchases was to boost its foreign position and thereby domestic and international confidence in its ability to perform its tasks. International institutions and ratings agencies had often pointed out the need for the Bank to build up its foreign reserves, especially in light of Iceland's high level of external debt. As a consequence of the improved external position and drop in facilities for credit institutions, the share of foreign assets grew from 32% to 67% of total assets. On the liabilities side, foreign liabilities decreased from just under 16% to just over 2% of total liabilities, capital and reserves, and the Bank had no foreign short-term liabilities at the end of the year. These changes have made the Central Bank's profitability highly susceptible to exchange rate changes. In his speech, the Chairman of the Board of Governors will also comment on the Bank's currency purchases.

The Central Bank's operations are not guided by any particular profit motive, unlike, for example, other financial institutions in a competitive environment. Specific objectives are set for the Central Bank by law. The most important are to contribute to price stability and an efficient and safe financial system. Conditions may easily arise where the Bank's efforts to attain its mandatory objectives create a temporary operating loss on its accounts.

There was a minor loss on the Central Bank's operations in 2003, amounting to 37 m.kr. Net interest income decreased by 1.9 b.kr., from 3.1 to 1.2 b.kr. Interest income went down by 5.1 b.kr. and interest expenditure excluding foreign exchange loss by 2.6 b.kr. Foreign exchange loss amounting to 1.9 b.kr. was posted to the accounts. The drop in interest income is explained by much lower claims on domestic credit institutions and lower interest rates in Iceland and abroad, compared with the previous year. As I have already mentioned, the Bank's asset composition is highly susceptible to exchange rate changes. The foreign exchange loss for 2003 is explained by the appreciation of the króna during the year and the fact that the US dollar has a heavier weight in the foreign reserve than in the currency basket against which the exchange rate is calculated. Consequently, in a year such as 2003 when the US dollar slid against other major currencies, the Central Bank sustains foreign exchange losses. In deciding the weight of individual currencies in its foreign reserves, the Bank has for many years aimed to minimise fluctuations in their foreign value, giving the reserve a different composition from that of the exchange rate basket, which entirely reflects the currency composition of Iceland's foreign trade. Rules on the composition of the bank's foreign reserves are reviewed annually. Roughly two-fifths of last year's foreign exchange loss was caused by the appreciation of the króna during the year and the rest by the depreciation of the US dollar. Central banks in neighbouring countries also suffered foreign exchange losses last year.

Operating expenditure in 2003 amounted to just over 1.1 b.kr., excluding a discretionary payment of pension fund commitments towards former staff of the National Economic Institute. The Central Bank paid half of the operating expenses of the National Economic Institute [which was abolished in 2002]. The discretionary pension payment made now was almost 200 m.kr. and the Bank's operating profit deteriorated by a corresponding amount. The transfer represented a full settlement on the part of the Central Bank. Another irregular expenditure item amounted to more than 30 m.kr. These two combined discretionary items account for around one-fifth of the Bank's total operating expenditure in 2003, but will not be a burden on its operations in the future. At the end of the year there were just over 110 full-time equivalent positions with the Bank, which is a similar figure to the year before.

As I mentioned earlier, the Central Bank's balance sheet shrank during the year and its composition changed significantly. Repurchase agreements with credit institutions decreased substantially, and thereby its króna-denominated claims on domestic credit institutions. In their place came foreign assets which carry much lower interest than króna-denominated claims. Exchange rate movements are a major determinant of the Bank's profitability. It is impossible to say what the outcome will be this year. The Bank's performance is not to be judged on the basis of its operating result, but rather its success in attaining its mandatory objectives. Since the latter part of 2002 inflation has been around or just within the Bank's target.

The Central Bank Act which was passed by parliament in May 2001 stipulates that its Supervisory Board shall be elected following a parliamentary election. Accordingly, a new Supervisory Board was elected in the spring. Ólafur G. Einarsson, Hannes Hólmsteinn Gissurarson, Jón Sigurðsson, Ragnar Arnalds and Sigríður Stefánsdóttir were re-elected. Two new Board members were elected: Helgi S. Guðmundsson and Ingibjörg Sólrún Gísladóttir. Davíð Aðalsteinsson and Þröstur Ólafsson left the Board. Davíð Aðalsteinsson had been a member of the Board for a continuous period since 1985, and its Deputy Chairman since 1998. Þröstur Ólafsson had been on the Board since 1985 apart from the period from 1990 to 1994. He was Chairman of what was then known as the Board of Directors from 1994 to 1998 and an Alternate Member from 1981 to 1985. On behalf of the Central Bank I would like to thank Davíð Aðalsteinsson and Þröstur Ólafsson for their excellent work on the Supervisory Board, and on behalf of those who had the opportunity to be on the Board with them I thank them for our pleasant work together. At the first meeting of the newly elected Supervisory Board, Ólafur G. Einarsson was elected Chairman and Helgi S. Guðmundsson Deputy Chairman. Jónas Hallgrímsson was later elected to the Supervisory Board in place of Jón Sigurðsson. The Supervisory Board held 20 meetings in 2003.

In August 2003, the Prime Minister appointed Jón Sigurðsson to the Board of Governors of the Central Bank of Iceland for a term of seven years, effective October 1, 2003. Jón Sigurðsson has an MBA and has been president of a business college, general manager of an employees' association, and project manager at the Iceland Chamber of Commerce and at the Confederation of Icelandic Employers. He has been a member of the board of directors of several companies, a member of the Supervisory Board of the Central Bank, and most recently chairman of the board of the Regional Development Fund of Iceland.

Ladies and Gentlemen:

I would like to thank the members of the Supervisory Board for their particularly pleasant cooperation and fine work. I also thank the Board of Governors and employees of the Bank for their very good work during the year and their fruitful collaboration with the Supervisory Board.