Davíð Oddsson: Review of the Icelandic economy

Address by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at the Bank's annual meeting, Reykjavik, 31 March 2006.

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Chairman of the Supervisory Board, Prime Minister, Cabinet Ministers, Ladies and Gentlemen:

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the 45th annual meeting since the Central Bank was established on April 7, 1961. The Bank's financial statements for the year 2005 have been ratified today by the Prime Minister. The Bank's annual report has also been published. It includes a report on the Bank's performance and a summary of how it has implemented its mandatory role.

The Chairman of the Supervisory Board devoted part of his address to Birgir Ísleifur Gunnarsson, the former Chairman of the Board of Governors. The present Governors endorse his words wholeheartedly. In this context I would like to draw attention to two points that the former Chairman of the Board of Governors mentioned at the last annual meeting. One concerned the Bank's forecast for inflation and the current account deficit. At that time the Bank forecast that the current account deficit would be equivalent to 12% of GDP in 2005 and inflation would be 2½% by today. Now it is clear that developments have been less favourable than was forecast and hoped. The current account deficit ended up at 16.6% of GDP and inflation is currently 4.5%.

Institutions are admittedly not accustomed to drawing attention to their forecasts if they do not come completely true. But what are the explanations?

It has transpired now that GDP grew last year by more than was forecast, and new national accounts data also show that the figure for 2004 was hugely underestimated. GDP growth then was 8.2%, the highest figure in Iceland since 1987, which was effectively a tax-free year [when Iceland moved onto a PAYE tax system]. Last year was eventful on the economic front. Private consumption grew at its fastest rate since 1987 and gross fixed capital formation faster than any year since 1971. Import growth has not been as brisk in any year since 1953 and the current account deficit broke previous records – although it should be added that as a result of income from soaring foreign asset holdings, Iceland's net external position only deteriorated slightly. Real wages were at a peak, unemployment at a minimum and direct foreign inward investment ran at a massive level. This inflated picture must be seen in the light of the very robust economic growth in the previous year, 2004, and strong growth in 2003 as well. Besides these large movements, a structural change in the domestic credit market made much more capital available to mortgage borrowers. Higher disposable income and net wealth also contributed to making this a unique period in Icelandic economic history.

Bearing all this in mind, it is probably surprising how modest a deviation was actually shown from the forecasts for inflation and the current account deficit. So far, house prices have been the main driver of inflation above the target. If house prices alone are excluded, Iceland's rate of inflation is low – and also in comparison with other European countries, for example. House price inflation was widely expected to stop sooner than it actually did. Monetary Bulletin, which was published yesterday, describes how the financial position of households has tightened due to a rise in short-term interest rates and in the lowest rates for new mortgages, compounded by the depreciation of the króna and higher inflation. For a number of familiar reasons, however, these monetary effects are not felt strongly yet, which is dampening efforts to slow down the economy. The increase in mortgage interest rates following yesterday's rise in the Central Bank's policy rate, however, represents an important contribution now.

Private consumption grew by almost 12% last year. Growth at such a pace is rare and can only be short-lived. Disposable income has been driven up by wage rises, a higher employment rate and tax cuts. Household wealth has also grown as real estate and equity prices rose substantially. Most indications are that asset prices are the main driver of private consumption growth. Housing prices in the Greater Reykjavík Area went up by 45% over the past year and a half, and equity prices by almost 96% over the same period. In the Central Bank's view, the real estate market will cool down significantly in the near future and private consumption growth will normalise next year. It might seem natural to ask whether the Bank's concerns about inflation will not vanish overnight then, because housing prices have been the only factor keeping inflation figures high. Unfortunately the matter is not so simple. There is no doubt that the Central Bank's policy rate measures have played a crucial part in helping the other index components to counteract house price inflation in the recent term. The movements in the exchange rate of the króna in the past few weeks exacerbate the challenge of steering inflation back onto a more moderate course.

Of course it would be easy to cite repeated comments and Central Bank declarations that the strength of the króna was unsustainable in the long run, and the many arguments supporting them. However, the Central Bank had hoped that the inevitable exchange rate adjustment would have occurred somewhat later than it actually did and would also have been more measured. The exchange rate adjustment would preferably have taken place after a slowdown in house price inflation and a substantial easing of the pressures which, according to newly published national accounts figures, were even greater than previously thought.

Under these circumstances, what the Central Bank must do is clear and it has no alternatives. "Letting inflation through", as it is sometimes called, without taking any measures, is not an option – neither as a policy nor according to the Bank's mandatory duties. For this reason, the Board of Governors decided yesterday to raise the policy interest rate by 0.75 percentage points. This is a greater increase than in recent decisions and reflects both the exchange rate movements that have taken place and the forecasts for economic developments that the Bank has now presented. No absolute commitment has been given about further policy rate hikes or whether the next steps will be large or small. That will depend on diverse economic events as they unfold. But the tasks assigned to the Bank are clear and it is willing to undertake them. Tight monetary policy may cause a temporary contraction in the economy while a satisfactory balance is restored. It is almost certain that too lax a stance would lead to a disorderly adjustment.

Sometimes the economic situation requires the Central Bank to encourage growth and stimulate initiative and enterprise. People see the Bank's actions then in that same positive light. Then conditions change and the Bank has to change course. Action is needed to counter overexpansion and overheating, and encourage saving, prudence and caution. Then the Bank has to resort to means which may have uncomfortable side-effects. Seen in that light, the Bank's profile and image appear different. The Central Bank's ability to use the powers at its disposal as conditions demand must not be changed. Those powers are limited and their effects often take a long time to emerge.

I began by mentioning that I would like to refer to two points from last year's address by the Chairman of the Board of Governors, and use them as headings for my discussion here of the Bank's two most important tasks at present, and in fact at all times. The first concerns the inflation target and figures connected with it. The second is the position and performance of financial companies. As it happens these two issues are generally interlinked, because decisions by financial companies have a strong impact on the first task, and imbalances in the Icelandic economy can affect international analysts' assessments of the position of the financial sector. But be that as it may.

I was interested to note that my cautious predecessor as Chairman of the Board of Governors described in his last address to the annual meeting how the strong growth in lending by the banks showed that they have overstepped the mark. Those were the words he used. He was discussing the impact on growth, overheating and inflationary pressures in the economy. I quote: "The surge in lending over the past two years is a cause of concern both for financial stability and the Central Bank's inflation target … Lending by the credit system as a whole increased by 16% in real terms last year." Unfortunately these cautionary words had no effect, because on top of the 16% increase in lending in real terms in 2004 came a further 25% increase in lending in real terms in 2005. This must be changed.

The Board of Governors of the Central Bank has held productive meetings with leaders of the banking sector to discuss this question among others. Statements have been issued in these meetings boding a more cautious approach in the future. The Board of Governors has no reason to doubt the integrity behind these promises. However, lending has continued to grow in the first months of this year, and at a faster pace than in 2004. The difference in practice is explained by the time it takes to clear promised loans which are in the pipeline. The Central Bank still has faith that these planned improvements will materialise, since a great deal is at stake.

In his address last year that I quoted from, the former Chairman of the Board of Governors also said that changes in their activities and strategies have left the banks more exposed to shocks originating in foreign markets. Recently we have seen instances of this. Admittedly, a lot of what was said in the much-quoted reports by international analysts is misrepresented, and some of it based on misunderstandings, wrong information and, occasionally, obvious antipathy towards the Icelandic banks and their activities. This is all regrettable and, in some cases, deserves to be condemned. But these cases are not the essence of the matter. The essential point is that the banking sector as a whole, or individual banks, are not in a position to refute this kind of coverage for once and for all. Another serious matter is that, at a certain time, these institutions are vulnerable to changes in supply or risk assessment in international banking and bond markets.

For its part, the Central Bank reiterates at this meeting that the underlying financial position of the Icelandic banking sector is very solid, fulfils the most stringent requirements and has easily passed all the stress tests conducted on it. This of course is the crucial issue. However, the scenario that we have witnessed since November must be taken very seriously. The Icelandic banking sector must address the shortcomings that international analysts repeatedly stumble over, regardless of whether these are exaggerated and overestimated. Lending growth must be reined in as promised. Certain financial institutions need to improve their communications to a significant degree, and a joint effort by them all could be worth considering. Hype and empty phrases must be avoided.

Some analysts in other countries have claimed that the market has already downgraded its ratings for the Icelandic banks some way below those issued by international ratings agencies. They claim that the ratings agencies cannot avoid moving into line with these market perceptions sooner or later. In a recent interview with [business paper] Viðskiptablaðið, I mentioned that if the financial institutions act appropriately, the outcome could turn out much more favourable for them. Once all the explanations have been made and the reforms are finished or close to completion, the market will be more likely to move into line with the rating agencies' outlook, and not vice versa. Since then, Standard & Poor's has issued sound ratings for Glitnir. Secondary market terms for Icelandic bonds improved as a result. The ratings companies have better knowledge of the Icelandic economy and financial sector that most other institutions that discuss them.

I have mentioned a number of issues here which Icelandic financial companies cannot avoid addressing. But in this respect we must not just preach to the banks. We need to take a critical look at ourselves and the other regulatory and supervisory agencies, monitor compliance with regulations and create a solid framework for the financial sector. It must be ensured that the institutions involved in these tasks can compete for capable staff who can soon tackle delicate issues and enjoy the confidence and respect of the markets. The government authorities, the Central Bank and the Financial Supervisory Authority (FME) have already made a formal agreement on joint monitoring of signs of weakness in financial institutions, and contingencies for responding to them. This agreement has been under preparation for a long time, is similar to those in effect in other advanced economies and has nothing to do as such with the current market unease.

Developments following the structural changes in the housing mortgage market have left the arrangements for the Housing Financing Fund in an untenable position. Moves to rectify this situation have been unduly delayed. Interest rate formation in this market has become unrealistic as a result, which in turn has an adverse effect on the Central Bank's efforts to cool the economy. The Prime Minister's recent declaration concerning the Housing Financing Fund is important and has met a positive response. But the declaration needs to be followed through in practice, as soon as possible.

A few years ago it was decided to separate the activities of the Central Bank and banking supervision, drawing on developments elsewhere, in particular in the UK, which had a widespread influence. This may well not have proved as successful everywhere as was hoped. Most of the banks in the UK are foreign banks, and the share of domestic banks is small. The opposite is true in Iceland. In spite of their large and growing activities abroad, all the Icelandic financial institutions are classified as resident companies. The international debate may now be turning in the opposite direction to that taken by Iceland and others when the banking supervision was separated from the Central Bank in its day. Iceland is a small country with rapidly expanding financial and banking business. It is a cause of some concern that supervisory and regulatory institutions have not grown correspondingly, although they have still performed their functions very well. The Icelandic banks are well aware of and understand the fundamental importance that strong institutions such as the Central Bank and FME have for assessments by ratings agencies and international analysts. The Board of Governors raises this point here for consideration in conceivable reforms of Iceland's financial institutional framework. But other action is needed as well.

In consultation between the Government of Iceland and the Central Bank, it has been decided to increase the Bank's foreign reserves in coming years and boost its capital position further, probably with foreign borrowing rather than by purchasing foreign currency in the markets. This is of course done on a long-term view and reflects ongoing changes in the external economic environment rather than the temporary market unease at present. Also, the Central Bank has recommended to the Ministry of Finance and the Government that special action should be taken to strengthen the foundations of the Icelandic bond market. The Treasury is in an unusually strong position at present and its debts are decreasing from one year to the next. Although the Treasury does not need to raise funds in the market, this does not prevent Treasury instruments from forming the backbone of active markets, as international experience shows us. The Ministry and Government have responded positively to the Central Bank's promptings and are now considering them.

The Icelandic Treasury is in a very strong position and the Icelandic economy is highly flexible and responsive. Icelandic financial institutions have never had a better foundation for building on than now. I am convinced that the warning bells that have been ringing will eventually be to our advantage. In our high-tech age we sometimes notice that it is the warning bells themselves that are broken and simply need to be mended. This may well be true of some of the bells that have been ringing recently. But we shall still take all the warning signs seriously and rectify everything that is rightly found wanting, no matter how trivial it may seem. Then, in the course of time, we will stand even stronger. A solid and powerful banking and financial system is the precondition for a dynamic society. Most of the people who can influence this good position are present at this meeting now. They are all urged to do their utmost. There is much at stake.