Davíð Oddsson: Promoting price stability and an efficient and safe financial system

Speech by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at the annual meeting of the National Federation of Pension Funds, Reykjavik, 18 May 2006.

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I thank the management of the National Federation of Pension Funds for inviting me to speak at this distinguished gathering.

Various tasks are assigned to the Central Bank in the Central Bank Act. Article 3 states that its main objective is to promote price stability, and that by agreement with the Prime Minister, the Central Bank can declare a numerical target for inflation. According to Article 4, the Central Bank shall undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and safe financial system. The Bank is thereby assigned a role connected with financial stability.

In my speech today I shall discuss these important Central Bank tasks, i.e. promoting price stability and an efficient and safe financial system. My concluding remarks will address the pension funds in particular.

Economic developments and the inflation target

The past few months have been eventful for the Icelandic economy. GDP growth has been robust over the past few years and a combination of factors caused private consumption to surge in 2005. Added to by large-scale imports for investment in the aluminium and hydropower sector, this development led to a significant current account deficit, the largest on record. One effect of the Central Bank's tight monetary stance was an appreciation of the króna. From mid-2004 to the end of 2005, the króna strengthened by 15% and the real effective exchange rate reached a record value. Against this background, and with such a wide current account deficit, the Central Bank had repeatedly described the strength of the króna as unsustainable. It would have to depreciate eventually, but exactly when was uncertain. However, it was hoped that this would not happen until the domestic economy had begun to cool.

Various factors which you are familiar with caused the króna to depreciate sooner and faster than was desirable. From mid-February to the second half of April it weakened by one-fifth. The trend then unwound and the króna regained some of its former value. The foreign exchange market calmed down and expectations have clearly taken a change for the better. However, further tremors cannot be ruled out, among other things due to changes in the value of other currencies, as recent examples have shown.

The króna is presently 15% weaker than in the closing weeks of last year. Of course this is a fairly sharp change over a short time. But the fact remains that the exchange rate index is currently hovering around the average for the period 2001-2005. I point this out because some of those who developed a sudden interest in the Icelandic economy overlooked the background to the depreciation of the króna so far this year which is important to keep in mind.

The Central Bank's main objective is to contribute to a twelve-month rate of inflation as close as possible to 2½%. For various reasons this target has proved difficult to attain recently. Probably the most important factor has been the structural changes in the mortgage loan market in 2004, with the easing of the Housing Financing Fund's lending rules and the subsequent entry of commercial banks and savings banks into the market. These changes caused real estate prices and private consumption to surge. In the recent term, house price inflation has accounted for the lion's share of the increase in the CPI. The Central Bank had hoped that house price inflation would slow down or stop before the króna began to weaken. If housing prices had risen by little or nothing, they could have offset the effects of the eventual depreciation. Regrettably the outcome was as I described, i.e. the króna fell sooner and faster than had been expected, and before real estate price inflation began to come down to a sufficient degree. Inflation will therefore clearly remain some way above target over the months to come.

A necessary economic adjustment lies ahead. One of the chief characteristics of the Icelandic economy is its high degree of flexibility and adaptability. This has often been demonstrated over the years and is one factor that international rating agencies repeatedly underline in their reports on Iceland's sovereign ratings. Thus there is every reason to expect that macroeconomic imbalances will ease quickly in the near term. In this process, investment is bound to contract sharply when the aluminium sector projects come to an end and private consumption will shrink as well, to leave very low or even zero GDP growth in 2007. Such a scenario is necessary to achieve acceptable internal and external balance. After the robust growth episode of recent years, it is time to slow down for a while. Experience shows that the exchange rate plays a key role in macroeconomic adjustment. Given the precedents, a depreciation will smooth out imbalances fairly swiftly.

In the current climate it is natural to ask whether the Central Bank has adequate instruments to keep inflation in check. The answer is yes. But it cannot be denied that a strong counter-effect by other forces, actions or expectations will obviously make the Central Bank's task more difficult. There are many reasons that inflation is above target and will remain there for some time, which I shall not dwell upon here. They have already been discussed in depth in the Central Bank's publications, for example. With a sufficiently tight monetary stance, the Central Bank is convinced that the inflation target will be attained, and this is its goal. It will require a sufficiently tight stance for a sufficiently long time. The Bank's most recent interest rate decision must be seen in this light. The rationale behind it was explained in a press release issued by the Central Bank this morning [May 18, 2006].

As I mentioned, the rise in the housing component explains the bulk of recent increases in the CPI. So it is not surprising that people have wondered whether the housing component should be included in the index on which the inflation target is based. The Central Bank has held this view, partly because changes in housing prices tend to be a leading indicator of private consumption and inflation, and also because over the years the CPI excluding the housing component has been more volatile than with it. Including the housing component in the CPI in effect makes the index less volatile. Of course it is natural to ask whether the right reference is being used for the inflation target and the Central Bank is obviously open for such discussion. However, it is absurd to change the CPI or strip it of certain components that become temporarily troublesome. The monetary policy framework and its implementation must not be changed except when the economy is in balance, and then only on the basis of long-term perspective, not vague short-term interests.

Financial stability

Over the past weeks and months, the Icelandic financial sector has been in the spotlight domestically and, not least, internationally. Not all of this publicity has necessarily been worth striving for. At the beginning of May the Central Bank published its annual *Financial Stability* report. It includes an analysis of macroeconomic stability and the position and strength of financial companies. The Central Bank's overall finding now was that in spite of rapid expansion and the macroeconomic imbalances that need to be tackled in the coming years, the Icelandic financial system is broadly sound.

The position of the large commercial banks is crucial for the financial markets. They have produced robust profits and their capital position is very strong. Among other things, this has been shown by a stress test applied by the FME [Financial Supervisory Authority] and the Central Bank's assessment of possible loan losses. These studies indicate firmly that the commercial banks' capital position is strong enough to withstand a significant economic crisis entailing several large shocks in tandem. Their financial foundations are therefore strong. An important part of the exceptionally high bank profitability in 2005 and the first months of 2006 stems from trading gains, but even if these items are excluded, their operating profit would still be very healthy.

Dynamic operations by Icelandic banks and the upgrading of their credit ratings and those of the Republic of Iceland have ensured easy access for them to international capital markets in recent years. This access has been used liberally and the banks have become more dependent on market financing.

The commercial banks' funding in international bond markets has changed recently. It was first noticed in the pricing of Credit Default Swaps in the autumn of 2005. Subsequently, yields rose on Icelandic bank bonds in the secondary market. These new conditions prompted extensive discussion by analysts with international banks and others about the position of the Icelandic banks. Attention focused in particular on the banks' business model, i.e. their high degree of leverage. It was pointed out that deposits account for a smaller share of the banks' funding that is customary among comparable banks in other countries. Thus Icelandic banks are more dependent on access to credit than is the norm. Also, the banks' enormous expansion has been noted and some observers wondered if it has not been unduly rapid. Whether or not the banks' positions and strategies deserve to be called into question is immaterial. The banks must take this dialogue seriously, by providing much more transparent information, correcting obvious misrepresentations and responding earnestly to criticism that may be justified. This is precisely what they have been doing in various ways and the results are already beginning to appear.

Macroeconomic imbalances, rapid banking sector growth and recent negative press prompted foreign investors to raise Iceland's risk profile. Higher required yields in the secondary market for bank bonds and for Credit Default Swaps indicate that the banks' financing costs have risen, at least for the time being. While there is nothing unusual about such a development, what is surprising is how much wider spreads have been required relative to the terms offered to banks with comparable credit ratings. Required yields have now fallen again in the secondary market and so has pricing of Icelandic banks' CDSs. The banks have also tapped international credit markets on favourable terms recently and have more than met their capital requirement so far this year. Their market position has therefore definitely improved again, which must be welcomed.

The banks have vigorously expanded in other countries in recent years. Most indications are that their foreign investments have been successful, in the Central Bank of Iceland's view. Their subsidiaries are sound financial companies subject to stringent supervision in their home countries, just like the parent companies in Iceland. Likewise, these companies operate in stable economies where the outlook is bright. At the end of 2005, two-thirds of the banks' consolidated lending was to foreign borrowers. In effect, therefore, overseas expansion has strengthened the banks' foundations. They are no longer so much at the mercy of economic fluctuations in Iceland or any other country. On the contrary, their risks are dispersed.

Pension funds

I shall now turn to the matters in which you are most directly involved, the position of pension funds in Iceland. Their position is remarkable in all respects, especially by international comparison. Most or all other industrial countries have rapidly ageing populations and face growing and serious fiscal concerns about future pension fund arrangements. Since their pension schemes are largely funded by taxation, a sharp rise in contributions is foreseeable over the next few decades. The reasons are large year-classes approaching retirement age, increased longevity and a lower birth rate. Conditions are quite different in Iceland, where age distribution is changing more slowly than in most countries with similar economies. Iceland's retirement pension system is based on all working persons saving a proportion of their wages in a fund which is then used to pay their pension. Taxes therefore does not need to be raised even if there is a proportional rise in the number of pensioners. In addition to pension funds, some pensions are paid through the national insurance benefit system and there are also voluntary supplementary pension savings schemes. Iceland's pension system thereby fulfils what has been considered international best practice in this field [the three-pillar system].

Total assets of Icelandic pension funds were equivalent to 120% of GDP at the end of 2005. No other pension system in the world is on such a strong footing. At the end of 2004, when total assets of Icelandic pension funds corresponded to more than 100% of GDP, the figure for the Netherlands was just over 100% and for the US 80-90%. In the overwhelming number of industrial countries, total assets of pension funds were equivalent to less than 20% of GDP, and the ratio was even lower than 10% in many countries, including Germany, Italy, Belgium, Austria, Sweden and Finland. By comparison, assets of Norway's Government Pension Fund (Petroleum Fund) last year were equivalent to 60% of GDP. One consequence is that the Icelandic Treasury's future pension payments burden is negligible compared to most other industrial countries. Of course this represents an enormous economic and social strength for Iceland. The pension funds' huge assets also impose a great responsibility on their management, who must invest these resources securely and profitably. Furthermore, relative to Iceland's economy, the pension funds are now at a size where they can have a massive impact on developments in the domestic financial sector.

In recent years, Icelandic pension funds have been consistently investing part of their disposable funds in foreign securities. They have considerable scope for making foreign portfolio investments, which by the end of March were estimated at almost 30% of their total assets. Holdings are mainly in foreign equity funds, but they have also invested in mixed funds and individual corporations. Pension funds have also been major players in the domestic equity market. At the end of March 2006, their estimated holdings exceeded 200 b.kr. and constituted 16% of their total assets. At the end of 2004, pension funds owned an estimated 12% of all equities listed on Iceland Stock Exchange. Corporate lending by pension funds has also grown rapidly. It is vital for pension funds to exercise the utmost care in their domestic equity investments, and to be cautious about wielding the power that these investments grant them. Likewise, diligence in corporate lending must be an important consideration for pension funds, to avoid an inordinate degree of risk. In my opinion, the pension funds' increased foreign investments, made strictly with their own interests in mind, are likely to affect currency developments favourably. When the króna remains strong for a prolonged period, pension funds are more likely to sell holdings denominated in it and invest those funds externally, with the effect of a stabiliser. And vice versa, they are likely to buy weak krónur after profit-taking, thereby contributing to a recovery of the domestic currency. In such a scenario, pension funds would serve a secondary role as a foreign exchange reserve, even if they were acting solely in the interest of their own clients.

The Central Bank's *Monetary Bulletin*, published in December 2005, included an in-depth article on *Pension funds – Future prospects and uncertainties* by Guðmundur Guðmundsson and Kristíana Baldursdóttir. The study found that pension fund assets could peak at more than double the value of GDP. However, the pension funds' future profitability is fraught with uncertainties. The most important criterion is return on investment, which could change and drastically affect the level of contributions required to sustain the pensions that the funds are expected to pay. Changes in life expectancy and disability expectancy will have some effect, although these are not as crucial as the uncertainty over return in investment. This indicates that the most important task ahead for pension fund management will be to optimise their return on investment, within the prudential limits that pension funds must respect. The foreseeable expansion of pension funds suggests that they will gradually have to step up their outward investment, which means that returns on foreign portfolios will be crucial for their future. Clear long-term strategies are needed on which to base their investments.

Ladies and Gentlemen:

Earlier I mentioned the extensive international coverage of the Icelandic economy and the position of its banking sector. The depth of the analysis has varied. Among the best informed observers of the Icelandic economy are the three international rating agencies that assign Iceland's sovereign credits ratings, and international organisations such as the OECD and IMF. All the rating agencies recently affirmed the sovereign rating, while one changed the outlook from stable to negative. The two agencies that have already assigned ratings to all the Icelandic commercial banks have also affirmed them, while the third agency recently awarded a first – and strong – rating to an Icelandic bank. Earlier this week, an IMF mission visiting Iceland published the concluding statement for its Article IV Consultation with the authorities. In it, the IMF says that the medium-term outlook for the Icelandic economy remains enviable and institutions and policy frameworks are strong. However, the current conditions require a tight fiscal and monetary stance to reduce macroeconomic imbalances. The Central Bank of Iceland will play its role in that effort.