Már Guðmundsson: Up from the depths?

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the Annual General Meeting of the Federation of Icelandic Fish Processing Plants, Reykjavík, 24 September 2010.

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Honoured guests:

I have called this speech, "Up from the depths?", a title that could refer to a number of things: analysis of the current situation and prospects for the future, for example, or the economic policy that could perhaps make the path swifter and/or safer. As regards the former, the questions are these: whether we have hit bottom, what the prospects are for an upswing, and how far we have to go until we achieve internal and external economic equilibrium, with a sustainable current account balance, inflation close to target, and labour and other factors of production utilised to a degree consistent with low, stable inflation. As regards the latter, the questions centre on what should be the contribution of various components of public policy in order for us to move forward on an even keel.

I will touch on some of these factors in my speech today. I will assess the current situation and the economic outlook. Then I will discuss how Iceland can emerge from a capital controls regime and reintegrate into global financial markets – which are prerequisites for a strong upswing in investment and output. Finally, I will say a few words about the growth outlook over a longer horizon.

Before I turn to Iceland's situation now and in the near future, I would like to place us in a wider international and historical context. Iceland is truly a small country, and individual positive or negative shocks can trigger economic short-term developments that deviate markedly from those in the rest of the world. But in the end, the possibilities are always limited by global trends.

Since the latter half of 2009, the global economy has begun to grow again after the recession that followed the peak of the 2008 financial crisis, but there are still a number of questions about what will come next. Output growth varies greatly from region to region, with a number of emerging economies soaring ahead while many of the developed economies hit hardest by the crisis are not growing fast enough to reduce unemployment, and near-term developments are a source of concern. At work here, to some extent, is the long-term tendency for the divide between emerging and developed countries to narrow. The trend is not necessarily a linear one, though; it tends to play out in fits and starts.

But in my opinion, more is involved. Last month I had the opportunity to attend a conference held annually in Jackson Hole, Wyoming, by the US Federal Reserve Bank of Kansas City.[1] At the conference, Professors Carmen and Vincent Reinhart presented the results of a broad-based study of output growth and other economic variables during the ten years before and after economic crises (40–70 countries in connection with major global crises, and 16 individual country crises).[2] The findings are very clear: economic activity has a tendency to be much weaker in the decade after a financial crisis than in the decade beforehand. There are probably a number of explanations for this:

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[1] See http://www.kansascityfed.org/publications/research/escp/archive.cfm.

[2] See Reinhart, Carmen M., and Vincent R. Reinhart (2010): After the Fall, http://www.kansascityfed.org/publicat/sympos/2010/reinhart - paper.pdf.

- GDP growth is often abnormally strong and, to a degree, unsustainable in the prelude to a financial crisis.
- Financial crises are preceded by debt accumulation and followed by a long process of deleveraging.
- Risk appetite subsides after a financial crisis, and what Keynes called "animal spirits" are tempered for a prolonged period of time.
- Production capacity is destroyed in a financial and economic crisis.
- Finally, economic policy becomes more complex, and there is more risk of error.

Of course, these developments are not inevitable, and the ultimate outcome depends also on policy choices. For example, it is clear that a number of mistakes played a key role in shaping the disaster that unfolded following the crash of 1929. I think, though, that we should be prepared for less output growth in the next few years than we expected before the crisis struck. The same can be said for profits in business overall, not to mention the financial sector, where return on equity was puffed up through leveraging that represented an unacceptable level of risk. It should also be borne in mind that economic policy based on an unrealistic level of growth in potential output has decidedly negative consequences.

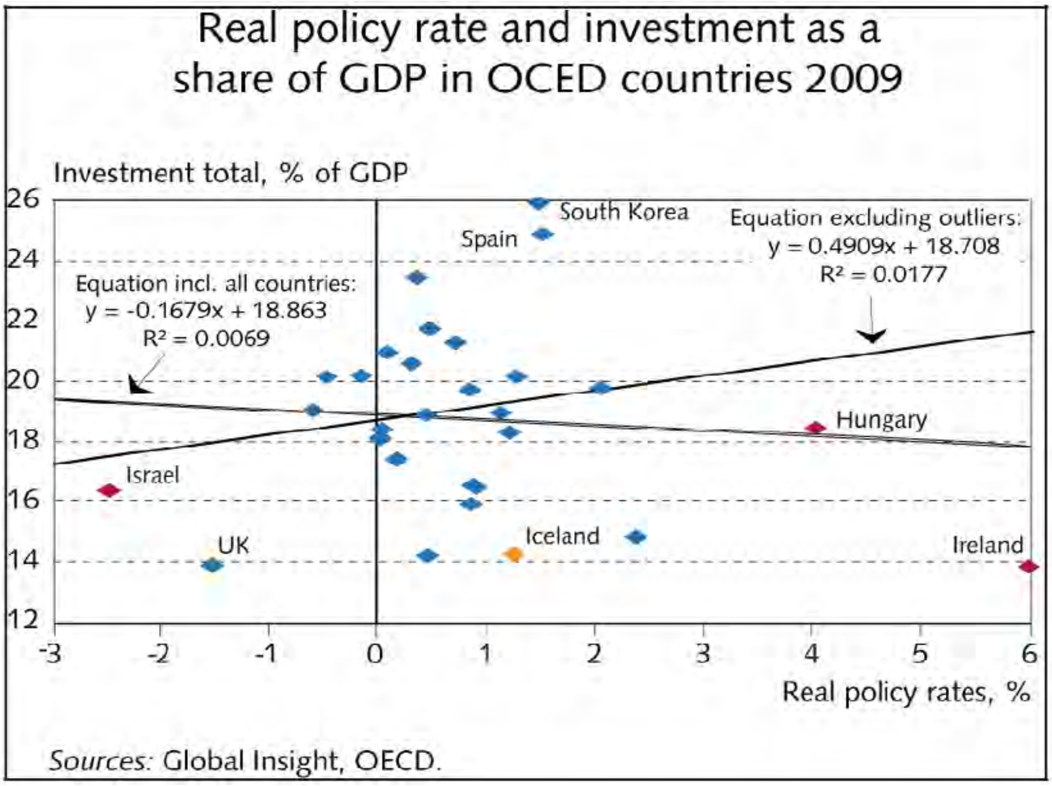
But let us return to Iceland in the here and now. There have been a number of positive developments in the Icelandic economy in the past few months. We have managed to put a floor under the exchange rate: since the beginning of the year, the króna has appreciated by over 12% in trade-weighted terms, and nearly 17% against the euro, without any intervention by the Central Bank. External imbalances have disappeared, and the underlying current account balance is now in surplus. Inflation has fallen from about 18% at the beginning of 2009 to the present 4½%. It is moving rapidly down to the Central Bank inflation target of 2½% and, excluding the effects of tax increases on price levels, will be at target early next year. Concerns that the Icelandic Government will fail to pay instalments on foreign loans in 2011 and 2012 have vanished as the foreign exchange reserves have grown, as I will expand on in a moment. In spite of the market's grave concerns about the debt situation in many smaller European countries, and in spite of rising CDS spreads on those same countries and the tendency towards contagion and a herd mentality in the market, Iceland's CDS spread has declined and is now considerably below those in the European countries whose debt problems have received the most press coverage.

But output growth is slow in coming, and in that regard, Iceland is far behind most other countries whose GDP began to grow late last year. At the moment it is quite difficult to interpret the signs, which are quite changeable in the current post-crisis turbulence. For example, quarterly GDP figures and various other statistics are quite volatile, changing from one revision to the next – a problem that is global in scope at present.

As a result, the Central Bank was sceptical when figures from Statistics Iceland indicated that GDP had begun to grow in the fourth quarter of 2009. The most recent numbers, which indicate a contraction, are more accurate, although I would not be surprised if the contraction proved somewhat smaller in the final figures. Most indicators suggest that we have hit bottom and that GDP will begin to grow in the latter half of this year, but I do not expect that growth to be strong.

In order for GDP growth to gain any real momentum, investment must rise from its current historical low. Gross capital formation will be just over 14% of GDP this year, the lowest investment ratio since World War II. In my opinion, although lower real interest rates will stimulate investment (other things being equal), other factors are more important, such as post-crisis risk aversion, bruised corporate balance sheets, uncertainty about demand and operating environments in the future, and drastically reduced access to foreign credit.

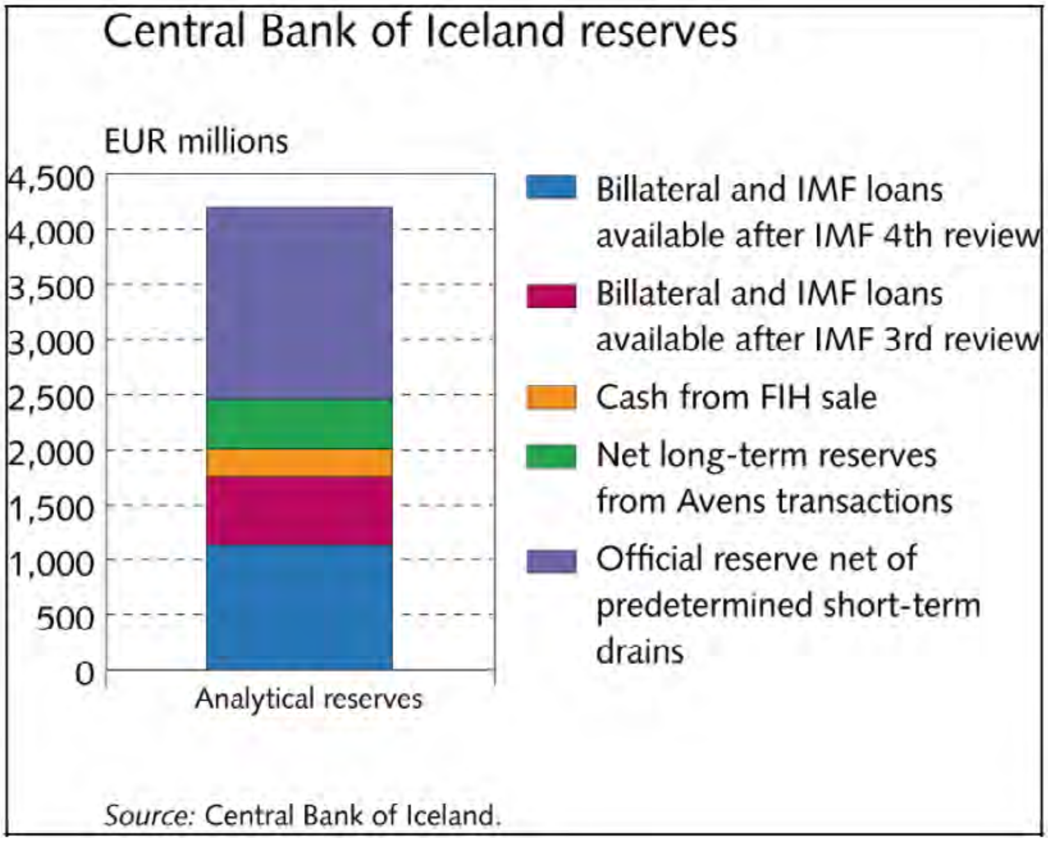
I think this chart, which shows the limited connection between real policy rates and investment ratios in OECD countries last year, supports this view. There is no significant relationship between the two, and if we exclude three outliers (Israel, Hungary, and Ireland), the inverse emerges. The UK and Iceland had similar investment ratios, even though the real policy rate was negative there and positive here. Of course, any simple cross-sectional correlation of this type should be interpreted with extreme caution, as the economic structure of countries varies and other important influencing factors are not taken into account. Furthermore, correlation is not the same as causation. Thus, in many countries, real policy rates are historically low because investment is weak. On the other hand, the relationship should be stronger than is shown here if real interest rates currently exert the strongest influence on investment ratios.

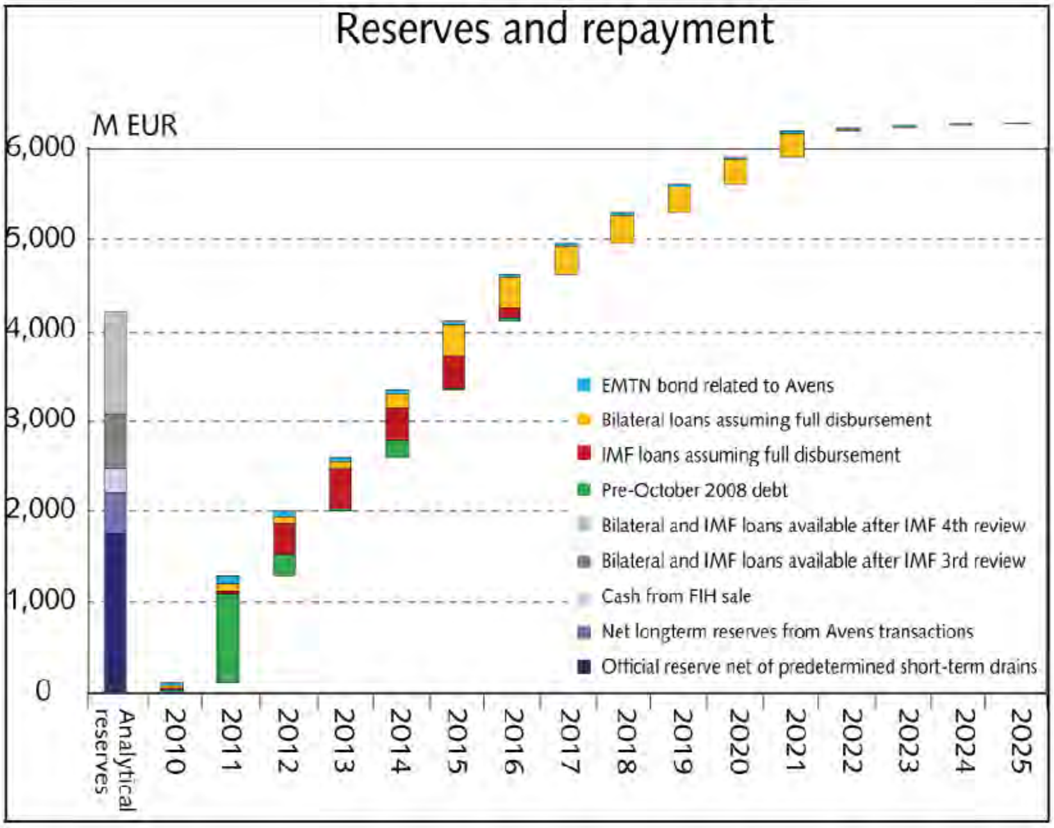


It is important for future output growth that Iceland re-establish a normal business relationship with the rest of the world, including lifting the capital controls and gaining access to foreign credit markets on acceptable terms. We have said that the prerequisites for capital account liberalisation are macroeconomic stability, sufficient foreign exchange reserves, and a financial system that can stand on its feet without capital controls. The first of these conditions has been met, and the next will be met upon successful conclusion of the third IMF review. The prospect of meeting the third condition in the next few months has improved in view of strong interim earnings reports from two of Iceland's large commercial banks and the recent Supreme Court judgment concerning the interest rate to be used for loans with nonbinding (illegal) exchange rate linkage clauses. But it would be a misunderstanding to assume that the timeframe can be measured in terms of weeks rather than months. We must receive the next tranche of the IMF loan after the third review, and we probably cannot pronounce the banks sound with respect to capital account liberalisation until late November. Furthermore, it is appropriate to bear in mind, as the recent unrest in the bond market shows, that there are short-term risks related to the removal of the controls; thus it is important that each step be well prepared. But if nothing unexpected arises, the time is coming closer, and preparation is underway within the Central Bank.

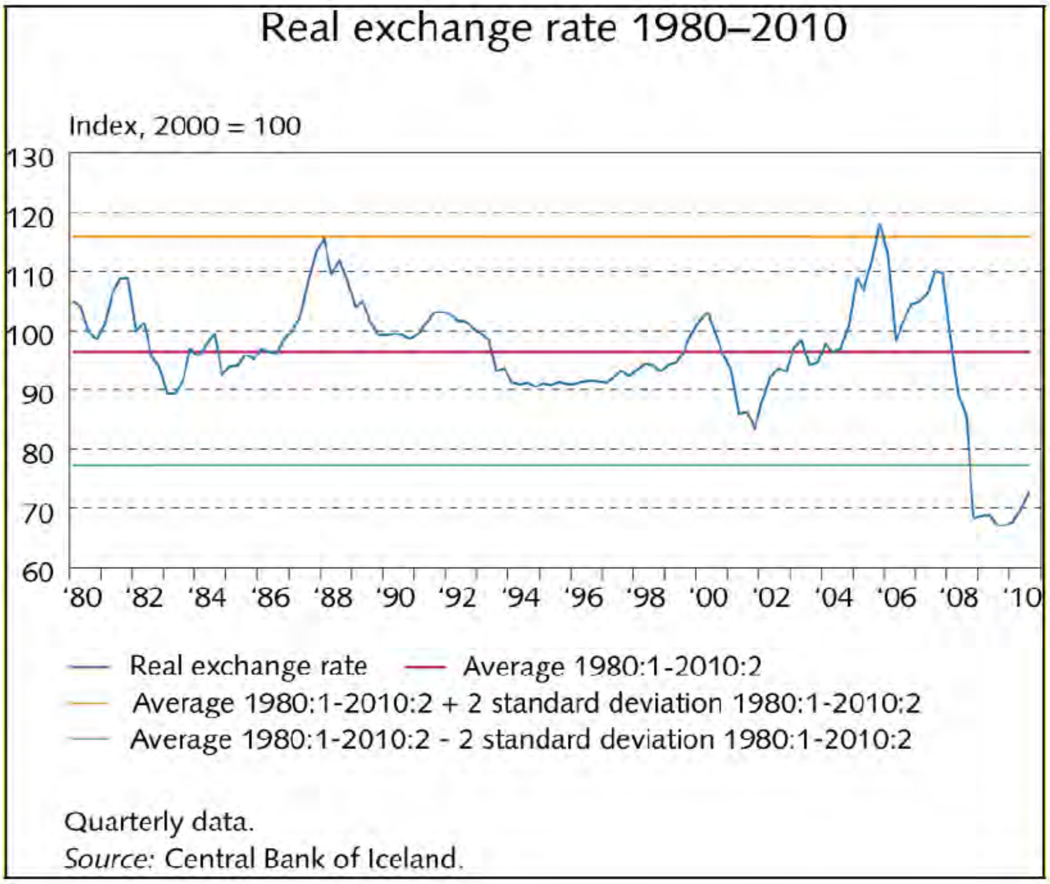
Of course, we won't make much progress in lifting the controls or gaining access to foreign credit markets if the Icelandic Government is considered unlikely to be able to fulfil its foreign loan obligations. Fortunately, though, once the next IMF review is complete, there will be no doubt about it. The foreign exchange reserves now total 1.7 billion euros, apart from short-term obligations. In the next few months, they will expand by 453 million euros due to transactions related to Avens, 255 million euros from the sale of FIH bank in Denmark, and 620 million euros following the third IMF review. The reserves will then exceed 3 billion euros. In comparison, the next two years' interest and instalments on two Treasury bond series total 1.5 billion euros, 400 million of which have already been bought back at a discount.

The following two charts show clearly how much foreign liquidity will improve. They show that the foreign exchange reserves will grow as large as 4 billion euros if Iceland draws the full amount of the loan facilities available through the IMF programme, and that they will cover the Treasury's instalments and interest payments through 2015. Of course, access to foreign credit markets will open up long before that time, and a part of the debt will be refinanced in the market.





I know that all of you who are assembled here today are very interested in how the exchange rate will develop once the Icelandic economy rights itself, hopefully within a few quarters. The chart below shows the real exchange rate of the króna, which is currently about 20% below its historical average but dropped as far as 33% below that average during the crisis. In my opinion, which is based on experience from other financial crises, it will take a very long time for it to return to that historical average. In this context, it is worth mentioning that after the Asian crisis, real exchange rates rose from their lowest point, but for many years afterward they were between 15% and 30% below their levels seven years pre-crisis, depending on the country. The equilibrium real exchange rate is now lower than before, and in the medium term it will remain lower than it will eventually be. The Central Bank is of the opinion that the real exchange rate is below equilibrium, but it is uncertain just how much. How the equilibrium real exchange rate will rise in coming years is uncertain as well.



While this complicates monetary policy, dealing with uncertainties is nothing new for monetary policy-makers. Furthermore, Iceland needs to substitute its borrowed reserves for non-borrowed reserves in the next few years. To that end, we have begun modest foreign exchange purchases in the market. These total 14 million euros, including special purchases in late August, before the regular purchasing programme began. So far, these transactions have not weakened the króna, and it could be argued that the long-term effects could just as well be in the other direction.

In closing, I wish to say this: If we succeed in restoring confidence in the Icelandic economy, which is the cornerstone of the IMF programme – and this includes lifting the capital controls and regaining access to foreign credit markets – we will be able to rise up from the depths. How quickly we can travel once we've reached the surface is another matter. It could be that we will have to content ourselves with less than before, but that is not a given. If we play our cards right, our small country – with its location and natural resources – can enjoy a wealth of possibilities. What we may never do again, however, is force our economy to grow faster than it is able to do – which has dire consequences for stability.