Davíð Oddsson: Economic and financial developments in Iceland

Address by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at the Bank's annual meeting, Reykjavik, 30 March 2007.

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Chairman of the Board of Governors, Prime Minister, Ministers of Government, Ladies and Gentlemen:

On behalf of the Board of Governors I welcome you all to this, the 46th annual meeting of the Central Bank of Iceland. At the Bank’s last annual meeting it was announced that the Government of Iceland and the Central Bank had been in consultation on the need to boost the Bank’s foreign reserves substantially and also to improve its capital position. Their motivation for doing so was not, however, that either position had weakened, nor that the Bank no longer met the benchmarks for capital and foreign reserves. For a long time the minimum foreign reserve has been set at an amount equivalent to three-months’ imports, and this level has always been ensured. However, the major changes – which could even be called revolutionary – that have taken place in Iceland’s financial sector over a relatively few years prompted the Board of Governors to regard it as prudent to take other factors into account, such as the size and scope of the financial sector. As far as the capital position is concerned, it can be said that clear guidelines are to be found in recent legislation on the Central Bank. The clause in the law dealing with the transfer to the Treasury makes some for provision for whether the Bank’s capital has reached a specified minimum relative to the size of the domestic credit system. The Central Bank Act states that an amount equal to two-thirds of the Central Bank’s profit shall be paid annually to the Treasury. However, the Bank pays only one-third of its profit to the Treasury if its capital is equivalent to less than of 2.25% of the amount of lending and domestic securities in the credit system.

At present the Bank’s capital is still a long way short of this legal reference level, and its annual profit will not suffice to strengthen it markedly anyway. Growth has not only soared in the Icelandic credit system, but on an increasing scale each year has also been associated with foreign markets, where credit institutions’ activities have expanded enormously. These changes also give grounds for considering other terms of reference for foreign reserves than import levels alone. As the Prime Minister stated in his speech earlier, the government responded positively to the points raised by Central Bank and authorised it to borrow abroad in the name of the Treasury in order to strengthen its foreign reserve substantially, while the government was also mandated by parliament to strengthen the Bank’s capital position. The Board of Governors would like to thank the government for such a good, firm response. The foreign loan that the Central Bank was authorised to take was its largest on behalf of the Treasury so far. It can only be said that this was a highly successful measure –in fact, a respected international financial journal ranked it one of the ten most successful international bond issues worldwide last year. The borrowing terms were very favourable and of course reflected the confidence enjoyed by the Republic of Iceland in the market.

The Central Bank’s greatly enhanced capital position and stronger foreign reserves do not signal any shift in its policy, but represent a natural response to changes in the environment in which the Bank operates.

At last year’s annual meeting we all had serious concerns about the peculiar discussion and sometimes unfounded speculation aired then about the Icelandic banks, their position and strength. There is no doubt that this debate and the ensuing events made conditions tighter for the banks for a while. The banks responded firmly to the uncomfortable position that had arisen. They made great efforts to explain the structure and organisation of the Icelandic banks. This was no half-hearted measure, but a steadfast and confident approach which produced results. The banks adjusted certain aspects of their operations and operating environment in response to relevant criticisms, and dismissed what was less relevant with explanations, reports and candid communication, at large meetings, small meetings and man-to-man, depending upon which was most productive. They needed temporarily to look beyond their traditional markets for funding, and unquestionably these conditions put their resources and management under strain. It can definitely be said that those involved passed this difficult test. The funding problem that loomed around this time a year ago is a thing of the past, terms in the secondary market have been normalised and market confidence has been restored. This is to be welcomed. What remains, however, is of course that people are now more aware of the widespread risks that the future may hold in store. Global market conditions can change suddenly. Credit access, which in recent times has been exceptionally favourable for Icelandic and other banks, may change suddenly if unexpected conditions arise. It is important to be prepared for such a contingency.

At the height of this furore, I would venture to say that the Central Bank made a strong contribution with its Financial Stability report, which was deemed to be professional, candid and in line with international best practice. The Bank's next Financial Stability report will be published towards the end of April.

Although these were not enviable times for financial companies, they definitely learned a lesson from this ordeal and are both more cautious and more aware of external influences than before.

Rapid and sweeping changes in the financial sector put a great strain on regulatory agencies, which may face an uphill struggle to keep up with the swift pace of developments. The same may undoubtedly be said about the Central Bank. After all, useful and supportive as these institutions may be, they neither can nor should play a leading role. That role can only be performed by the financial companies themselves. Because they rely so heavily on open access to credit markets, it is crucial for them to enjoy the confidence of their creditors. In this respect like many others, credibility is a fragile thing and a very high price can be paid for losing it.

Turbulence in global markets is sure to continue. Naturally people try to read the signs and foresee the most important parameters, in order to adapt to them in good time or respond sensibly. Important as it is to keep a close watch on developments and changes in global markets, what matters most of all is to be strong and well-positioned enough to withstand the most unexpected shocks.

Global liquidity has been exceptionally abundant in recent years, and has been widely tapped on good terms. The benefits of resourcefulness and bold, quick action can be realised to the full in such circumstances. It is impossible to rule out that such a climate will persist for a long while, but this is by no means certain. And when a change does take place, it may be caused by unexpected circumstances and strike quickly. It is then that caution and prudence prove most effective. Interest rates have been on the increase recently in most parts of the world and capital is not as cheap as before, although it can still be procured at very low rates. Conditions in capital markets in general are therefore more likely to tighten in the coming years.

Influential as economic developments on both sides of the Atlantic may be for the Icelandic economy, the way we handle our own affairs is still important. The crucial consideration is to achieve a rapid reduction in macroeconomic imbalances and restore stability. To do so, domestic demand must be reduced. Part of this process will occur automatically with the completion of ongoing investments in the aluminium and power sectors.

Much has changed since the meeting a year ago, some things for the better, and others not. The current account deficit run up last year will not be forgotten for a long time – it even managed to trump the most pessimistic forecasts. Fortunately, clear signs of a gradual contraction are now visible, but this improvement is likely to be slower than we had previously expected, especially on account of foreign debt service.

The Board of Governors of the Central Bank decided yesterday to leave the Bank's policy rate unchanged at 14.25%, at the level where it has been since December. By contrast, the day before last year's annual meeting, the Board of Governors raised the policy rate by 0.75 percentage points. These two decisions hopefully give some indication of where the Central Bank considers that it currently stands in the battle against inflation. This battle is a priority and there is no doubt that a successful outcome is very much in the national interest, not least for young people who have taken on heavy liabilities to secure themselves short-term or long-term housing. Household debt with the deposit money banks has surged in Iceland in recent years. However, debt service as a proportion of income has not grown, due to the more favourable credit terms now available, as well as rising incomes. Loan delinquency is still minimal. Both these indicators are very positive. However, this does not alter the Central Bank's concerns about excessive borrowing, or at least very precarious borrowing, which could make the foreseeable economic contraction very tough for indebted households, and in some cases insurmountable. In such conditions, rising inflation could deal many households a heavy blow.

Some people have responded to Iceland's relatively high interest rates and price indexation by switching their debts to foreign currencies, but the benefits could prove short-lived if the króna depreciates. A depreciation would be instantly reflected in repayments on these foreign loans. Its impact on domestic indexed borrowing would be less and come later.

At the last annual meeting, it was pointed out that the Central Bank had strongly encouraged financial institutions to curtail their credit growth at that time which, in the Bank's view, had gone beyond all reasonable bounds. They responded positively to the Bank's recommendations, and there was no question that credit growth slowed substantially. However, there are now many indications of a return to the earlier situation, so the Bank must reiterate its words of warning.

At the same time as the Central Bank announced its interest rate decision yesterday, it published *Monetary Bulletin*. This outlines the main assumptions behind the Bank's decision along with indications about its policy in the near future and the viewpoints it considers important to bear in mind for economic policy. In the current edition, major changes were made to the assumptions behind the baseline forecast, which enhance both the credibility of the forecast and monetary policy transparency. By doing so, the Central Bank of Iceland joined the vanguard of the inflation-targeting central banks. *Monetary Bulletin* reveals that inflation developments have turned rather more favourable than the Bank's previous forecast had indicated, and although underlying inflation was somewhat higher in February and March than was hoped, the Bank expects both headline and underlying inflation to decrease rapidly in the next months. By both measures, inflation will be close to target from the middle of 2008. There is no doubt that this outcome is largely thanks to the tight monetary stance, which included raising the policy rate by 3.75 percentage points last year.

As usual it should be pointed out – and especially in the current climate – that exchange rate uncertainties can complicate this picture. The exchange rate has been relatively stable after the adjustment that took place in the first half of last year, and the króna is currently somewhat stronger than historical measures would warrant, although it should be admitted that determinism is probably not the most suitable approach for assessing currency developments. One reason for uncertainty about the exchange rate is the large current account deficit, as well as the fact that it can easily be driven by factors over which we have no control, given how closely Iceland's financial sector is now integrated with global financial markets.

A central bank with a legislative and regulatory remit to target inflation is of course pleased with such inflation developments, but would prefer them to be built on a more solid foundation. Domestic demand growth has declined, but rather more slowly than the Bank had hoped. The current account deficit is large and will also contract more slowly than the Bank would have desired. Demand remains buoyant in the housing market and there are indications that the rate of credit growth may be on the increase again. For these and other reasons, the Bank will remain on the alert and not ease its monetary stance until even clearer signs emerge that a lasting change has been established.

Equity prices have soared in Iceland in recent years. One explanation for the increase may be that Icelandic companies have been undervalued by the markets, for example relative to comparable businesses in other countries, and another that bold and determined investment ventures have driven up their value. But risk and gain often go hand in hand. Sometimes the stakes may be raised too high. It has long been customary to pay a premium for attractive investment options. Such goodwill used to be depreciated in companies' accounts over a long period and rarely affected their operations. The situation has changed whereby companies now need to make impairment tests of the goodwill they enter on the asset side of their balance sheets. If their original ventures fall flat, the goodwill must be depreciated accordingly. Thus there is a risk, if conditions deteriorate, that this rule could amplify a company's negative results at the worst possible time. Goodwill totalling more than 500 b.kr. was entered in the financial statements for 2006 of companies listed on Iceland Stock Exchange, and at certain companies, goodwill and other intangibles account for more than half of the total assets on their books. This is a cause for some deliberation.

Although the Central Bank's main function on occasions such as this is to draw particular attention to causes for concern, it should of course take note, like everyone else, of the factors conducive to strengthening the long-term economic outlook. Iceland's economy is advanced, transparent and vibrant. Its strong fiscal position is exemplary, and the population is relatively young, well educated and quick to adapt to technological and scientific innovations of all kinds. A strong pension system has been built up and – unlike other countries that have great fears about the future of their pension systems and their sustainability – it is clear that Iceland's pension system is becoming increasingly stronger. Admittedly it is still not mature enough to have begun to pay out a representative proportion of its owners' lifetime earnings, but this proportion is growing every year and all the pointers indicate that, for the foreseeable future, it will be highly sustainable. Thus the pension system is going from strength to strength in Iceland, at the same time as significant weaknesses are coming to the fore in many comparable economies. Real incomes in Iceland rank with the highest in the world, and unemployment with the lowest. Large-scale investments have recently been made which will generate handsome export revenues. Traditional sectors currently enjoy secure markets and high product prices. Undeniably this picture looks very bright and many more positive signs could be cited. But this does not alter the fact that, as I said earlier, the foundation has been precarious in many areas and the medium term will have a decisive significance for the outcome. Uncertainties abound and many households in Iceland thread a narrow path of debt and wages, where if they lose their footing, the fall could be heavy. Thus caution, steadfastness and self-control are called for in all areas of the economy – in other words, the maxim that “the doors of pleasure should not be thrown wide open” still applies. As far as the Central Bank is concerned, ensuring low inflation is its most important function today and in the future. And that picture is growing brighter, although care still needs to be exercised.