

Davíð Oddsson: The challenges of globalisation for small open economies with independent currencies

Opening address by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, at a conference on The Challenges of Globalisation for Small Open Economies with Independent Currencies, Reykjavík, 1 June 2007.

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On behalf of the Board of Governors of the Central Bank of Iceland I welcome the cooperation between the Bank and the International Monetary Fund on organising the conference that is now commencing. In fact I consider the theme of this conference very apt and take the liberty of stating that a better location for such discussion could hardly be found. This claim is not only based on the fact that Iceland is currently staging a kind of practical experiment in this field. While it can be argued that such experiments are taking place in many other countries, the advantage of Iceland's experiment is that its economic developments happen to have been quite notable over the past few years. Certain aspects of recent events raise significant questions for this conference.

There is no question that Iceland was a relative latecomer to the top league of active market economies: for a long time, Iceland's rules and norms did not qualify it for inclusion. But Iceland's economic framework has been completely transformed in the space of a relatively few years and its business world has undergone enormous upheavals at the same time. Looking at just the past four or five years, there is no doubt that certain laws of economics have been stretched to their limits and, in order to convince outsiders that the stakes have not been set too high, we have had to insist – and rightly so, I hope – that Iceland's economic environment has various advantages that are not immediately obvious to those who are accustomed to operating in larger and more restrictive conditions. Here there is great flexibility, official measures are very transparent and channels of communication are shorter, which enables easier decision-making so that households, businesses and the authorities are quicker to respond to economic incentives or challenges than is the case elsewhere.

To give you all a more complex and interesting topic to discuss at a conference such as this, the government itself promoted a number of measures that will benefit Iceland and its people in the long run. However, their timing and scope may have been more questionable. Thus the government itself was mostly responsible for attracting the largest single investment that has ever been made in Iceland, to which the state-owned power company, Landsvirkjun, had to respond by matching it with an investment of its own on the same scale. The inflow of capital was enormous. As if this was not enough, public sector involvement in housing finance was reformed around the same time; this structural reorganisation had unexpected multiplier effects when the recently privatised commercial banks eagerly followed that lead and ran ahead along the same path even faster than the policy makers had expected.

At the same time, Icelandic banks and financial institutions have been establishing their influence in neighbouring foreign markets and, to some degree, more distant ones. The banks have expanded rapidly and are now very large relative to Iceland's domestic economy, and in fact by any measure. Their international activities have also created a new situation that has sometimes been called "the problem of explaining the Icelandic economy". Although I feel that this problem is overstated because it must surely be temporary, it cannot be denied that the Icelandic currency itself, and its small size, are recurrent themes. The economic factors I mentioned earlier have driven strong inflationary pressures in Iceland, which have partly appeared in the form of higher measured inflation, but have to some extent been contained by Central Bank policy rate decisions, which in turn have affected the exchange rate of the Icelandic króna, at least for some while now. And in combination, these two factors have raised yet another question that is relevant to this conference.

That is to say, these special conditions have inspired new investors, the carry traders, to venture to our shores. These modern-day Vikings try their fortune in distant places in the hope of quick gain and handsome returns, which they can no longer find closer to home. What will happen when these bold hunters of yields and expectations suddenly lose their nerve? Or their appetite? Regardless of whether this is caused by events that have occurred somewhere else and under completely different conditions from here, or due to persistent rumours, speculation and theories about the situation in Iceland and risks that have little or no foundation at that time. Will they load everything aboard and sail off, like the

Vikings in the past, with what they have managed to gather up, and look for shelter with their bounty against real or imaginary threats? If this happens, might the high-yield countries suffer a shock? And if so, will that shock be felt the most by the smallest countries, where investors naturally have the least knowledge and confidence? Then the question will arise about the impact that all this will have on the effectiveness of the Central Bank's policies for controlling inflation developments, and whether we might be better off locked away inside one of the super-currencies, obeying the laws that apply there and at the mercy of the decisions of others.

All these considerations and many others can stoke the fires of debate at this conference in Iceland. Some people maintain that the incredible gains that Iceland has made over a very few years could only have been achieved because the country had its own currency. Others say that the consequences may be more difficult to deal with and more persistent precisely because the country has its own currency and is not under the wing of a large currency area. Yet others claim that if Iceland fixes itself against another currency and obeys the laws of others – interest rates based on what is happening in France, Italy and Germany and not in Iceland – that this will produce a more cautious attitude up here in the frozen north, the appetite for risk will diminish and economic developments will take a healthier turn. Thus there are countless questions, of which I have mentioned only a few. Of course I have taken care in these opening remarks to leave all these questions open for those who follow. It is a particular pleasure to have lured so many distinguished guests here to do theoretical battle about these questions. It is equally welcome to give our leading experts the opportunity and time to ponder these issues and present their own views. So everything promises a rewarding outcome from this conference. It has been organised with ample reason, in the right place and at the right time, and with exceptionally qualified speakers.