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, 28 March 2008.

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Mr. Chairman, Mr. Prime Minister, honourable Ministers, Ladies and Gentlemen:

The Board of Governors of the Central Bank of Iceland welcomes you all to the Bank's 47th Annual Meeting. At the recently concluded meeting of the Supervisory Board, the Prime Minister ratified the Bank's annual accounts, which are available here, together with the Annual Report for the year 2007.

Here in Iceland there are various cliffs that people scale in order to gain a better overview of the surroundings than they would have on the level ground below. From this vantage point, the Central Bank at Arnarhóll, the telescope points, in all weathers, at inflation – at how it develops and how it behaves. It focuses both on the components that are measured with the officially required tools and on those that lie beneath the surface, not least on the indicators and expectations concerning how these components of inflation are likely to manifest themselves in the near future. As is well known, this guardianship and scrutiny constitutes the core of the Central Bank's legally mandated role, and the fact that the Bank should be assigned the task of containing inflation is not absurd, nor is it a function of obsession or blind fundamentalist belief that a particular aspect of economic policy implementation should take absolute priority over all others.

Both in Iceland and in most other countries, there is abundant experience to support the conviction that inflation is extremely harmful if it becomes immoderately high. It becomes a serious problem if deviations persist, and it will cause important damage if it continues to grow and the Central Bank cannot contain it through conventional measures within a reasonable period of time. It is possible to advance theoretical support for the idea that the Central Bank alone could hold inflation down, but in order to do so the Bank would have to implement its measures with such force and rigidity that its actions might have an extremely negative effect on many other aspects of people's lives. It is therefore vital that those who are most influential in determining Iceland's financial and economic development pull together as one in order to fight rising inflation. Short-term interests and viewpoints must yield in favour of the greater goal. To be sure, the Central Bank is assigned the task of containing inflation with particular acuity on behalf of the public and the authorities, and the Bank is required to wield the weapons in its arsenal whether people like it or not. The Bank attempts to carry out that task as well as it possibly can. In the service of that task, the Bank is granted more independence than are most government-owned institutions. One could ask why this is so. What makes it necessary?

The explanation lies not least in the fact that the legislature – in Iceland as elsewhere – has realised that the battle against the disease called inflation could be lengthy and uncomfortable. As time passes, the treatment of the disease could generate unpleasant side effects, and it might be tempting to do away with those side effects in the vain hope that the illness will somehow cure itself. Indeed, we have heard this irresponsible notion expressed in various quarters recently. Anyone who has come down with a persistent illness is familiar with the physician's demand that the patient complete the course of treatment prescribed to him. If he does not, he runs the risk that the bacteria attacking him will become resistant to the medicine best suited to fight them, with the result that the medicine will work poorly or not at all the next time it is needed. The tactic of last resort under such circumstances is to prescribe a much stronger dose, which inevitably produces much more dire side effects. If a central bank, either the one located in this building or another one, should change its course in mid-stream because of escalating pressure stemming from painful side effects, it is hardly likely that such a bank would be taken seriously when it next attempted to mount a campaign against inflation. The independence of the Central Bank exists not least to guarantee that those wishing to take the line of least resistance, hoping that the illness will cure itself, cannot bring undue pressure to bear. The Central Bank's independence also provides the government a buffer against such pressure.

The fact is that the Central Bank neither can nor wants to ignore the figures that tell us that it is far from having achieved its goal of bringing inflation down to targeted levels. There are many explanations for this – or excuses, perhaps – but as has always been the case, many excuses are usually worse than one. And of course, the main explanation is that growth, and demand have been greater and more enduring than economic indicators – and therefore the Bank's forecasts – suggested. This has required lengthier and more invasive treatment than was previously intended. And while the Central Bank does not consider this a desirable state of affairs, it is convinced that this treatment is inevitable and necessary.

Ladies and Gentlemen:

The twelve months that have elapsed since the Bank's last Annual Meeting have been eventful in many ways. As regards the economy and the financial markets in particular, the season has been harsh and often stormy, and now, on March 28th, when the vernal equinox is past and the days are lengthening visibly with every week that passes, there are few signs that spring is near for the economy. And despite the fact that this rather pessimistic statement is anything but an exaggeration, it is surprising to realise how many people are still convinced that things have seldom been better than they are now, and that Icelanders are enjoying boom times in most respects. But is this really as astounding as it might seem at first? Our employment levels are very high, excess demand for labour is considerable, public access to credit institutions has been subject to few limitations until very recently, and though credit has not exactly been cheap, terms have not been as unfavourable as one might expect, thanks to high levels of employment and rising disposable income. The Treasury has been operated with an acceptable surplus and is well able to meet the demands made of it. As a result, there is considerable pressure to increase government expenditure, though neither the labour market nor other economic conditions have yet required such increases. The government must be steadfast in resisting the pressure to increase expenditure at a time when it cannot honestly be said that the money doesn't exist. But this steadfastness is nonetheless necessary, for it is virtually certain that there will be a genuine and growing need for that money at some stage, and the damage done will be considerable indeed if we are short-sighted enough to forget ourselves in the expansiveness that accompanies an economic boom and then cannot meet the demands of the lean years quickly and reliably.

There was a time when growing debt accumulation by the government posed a genuine threat, and it was promised that this would cease. Those promises were fulfilled, and it is a welcome relief to see how much conditions have improved. As a result, Iceland has garnered the respect of international credit rating agencies and has been placed on a par with some of the most powerful nations on the globe, which has not only strengthened the government but has also enhanced the position of Icelandic corporations and institutions in the international markets. The positive credit rating enjoyed by the Republic of Iceland has most certainly been worth its weight in gold for all those connected with the country. Recently there has been a bit of tension in this regard; credit default swap spreads have become wider than they were previously, and more unfavourable for the Icelandic government. This development is utterly out of context with the position of the Republic of Iceland itself. It has occurred primarily for two reasons. Iceland's overall level of debt has grown to an uncomfortable degree, and the CDS spreads of Icelandic banks have reached exceptional heights despite their excellent capital adequacy ratios, their steady history of profitability, and the improvements they have made in their funding procedures relative to, for example, two years ago. The present credit crunch and difficulties in the market are far from being uniquely Icelandic; they are a global phenomenon, and the recent turnaround seems to have taken everyone by surprise. When the current problems reared their heads in mid-2007, many clung to the hope that these headwinds would be short-lived and soon pacified. The general feeling seems to have been that there was still a glut of capital around the world, and that the temporary distrust in the market – even a sort of misunderstanding of the market – would vanish as soon as it became clear that the sub-prime mortgage market in the United States, despite its scope and size, was only a drop in the proverbial ocean of international finance, and that cheap capital must surely be unleashed anew and the Utopian dream would take the market in its arms once more. At which point, all would be happy once again and all unpleasantness a forgotten dream. But the sub-prime mortgage market did not stand alone, and various events directly or indirectly related to it delayed expectations of a recovery, and the new lines of defence were drawn at the beginning of the year and in the weeks that followed. According to the Utopians, when annual results began to show after the first of the year and the genuinely positive state of events was revealed, the phantom problem would wash away on the outgoing tide.

There is the danger that those who placed their trust in such a beneficent outcome used their time far less well than they should have from August 2007 onward. The CEO of one of the largest banks in the world said, “While the band plays, we dance.” He was forced to resign shortly thereafter, when the bank demonstrated a shocking operating loss, but with a fat fund in his pockets as a reward for his foresight and progressive thinking. For similar reasons, many will have more difficulty waiting for better times. Of course, it is far from inconceivable that strong gusts of wind could come from any direction, dispersing pitch-black storm clouds in a moment’s time, bringing leveraged buyouts of heavily indebted companies under the aegis of credit institutions offering minimum terms and slick collateral, and bright, sunny morning would smile on markets in Iceland and elsewhere. But even though this is not inconceivable, and though history shows that the market is living proof of the most improbable outcomes, the likelihood is that the probability of winning the wait-and-hope game is measurably poorer than that accompanying the purchase of a Lotto ticket. Therefore, it is appropriate to assume that the situation will not right itself very much in the short term, and if it does right itself to any measurable degree, it will hardly return to its prior state. If people haven’t prepared themselves already, there is no reason to wait. We must seek all possible ways to strengthen the liquidity position of companies – particularly financial companies – and at the same time we must re-examine market models. In athletic terms, one could say that this means that now is the time to consolidate our defences and be content with a goal if opportunities emerge in spite of all odds. Though exaggerated pessimism is obviously unnecessary, it is as bad or worse to paint the situation in rosy colours for the benefit of ourselves and the public and imply that there is some sort of magical solution to the problem that faces us. As the saying goes, “Lying to others is a wicked bent; lying to oneself breeds a lethal event.”

The fact that the past few months have seen dubious conduct in the international markets is another matter altogether. Recent examples include a rumourmongering campaign against the British bank HBOS, causing substantial, though temporary, damage. That case is now being investigated. There is also an example from Ireland, which suggests that the same took place there. And it cannot be denied that the attacks that have been made on Iceland’s bank and central government – which was subjected to CDS spreads of up to an absurd 400 basis points – give off an unpleasant odour of unscrupulous dealers who have decided to make a last stab at breaking down the Icelandic financial system. They won’t get away with it. But it must be a logical next step to consider an international investigation on such attempts to bring a healthy economic system to its knees.

Ladies and Gentlemen:

Just a year ago, at the Bank’s Annual Meeting early in 2007, I warned against tempting people with foreign loans when they didn’t have the income to support the risk. I have done the same on many other occasions. My colleagues here on the Board of Governors have also stressed this point repeatedly. But the thing that we have been most on the defensive against got us in the end. People set little store by our words of caution, and now many of them are licking their wounds as a result of recent developments.

Even though it is fashionable at present to badmouth our local currency – even among those who ought to see it as their duty to refrain from indulging in such calumny – most currencies, large and small alike, have fluctuated wildly in the recent market turbulence; and it can easily happen that as soon as the króna depreciates, the yen and the Swiss franc, for example, appreciate even more, and borrowers who have been following the Pied Piper of Hamelin along the path of foreign loans end up trapped by their own gullibility.

Despite the headwinds that face us now, not least in connection with the international financial markets and the profound impact that they could have on business here in Iceland, it is not necessarily a given that the Icelandic nation is careening headlong into a recession. It is much more likely that we will experience a slowdown and, at worst, a sharp economic dip that need not be long-lasting. We have experienced the like before and have been quick to shake off the effects of it with the adaptability that the Icelandic nation has so often demonstrated. It is reasonably clear, however, that the national economy will not achieve any real equilibrium unless there is a contraction in demand.

But it is right to keep in mind that, if we drag our heels and delay furling our sails, it is not impossible that it will take very little in the way of rough seas to tumble us into something that could accurately be called a recession. And in that case, we would have only ourselves to blame. We must not let such a thing happen.

Ladies and Gentlemen:

We welcome the interest and amicability that you show in attending this meeting. In older times, it was considered appropriate for central banks to keep their distance, to be silent and even somewhat inscrutable, for that standoffishness was thought conducive to creating the image that the persons behind the banks had quasi-supernatural powers, that they possessed information available to no one else and could avail themselves of preternatural tricks and stratagems to address a wide variety of problems. But times have changed – and that is for the better. Central banks must not let down their guard. Their policies and aims should be clear, and their actions should be consistent with those policies and aims. The independence of the Central Bank of Iceland remains a cornerstone of its operations, and any responsible person should protect and fortify that independence. This does not mean that the Central Bank is above all criticism, of course. Actually, there are solid reasons for claiming that the independence enjoyed by the Bank justifies its being subjected to more incisive criticism than it should otherwise tolerate. The Central Bank itself takes the view that criticism of its work is desirable. Within the Bank, all are aware that, for every decision made, several options were possible, and the decision to embrace one option over all others is accompanied by a variety of consequences. In making decisions under such circumstances, there must be ample room for comment, contrasting viewpoints, and criticism. And – thank goodness – the Central Bank has not been free of such comments and criticism. Indeed, most comments have been presented in a responsible and appropriate manner and have been both helpful and useful in the broadest sense. That is not to say that there aren't exceptions – predictable canting litanies that are of little use to anyone – but valuable comments have nonetheless been salient and they are heard and considered.

Last Tuesday, after the Easter holidays, the Bank announced several amendments to its internal rules and terms. Those amendments were designed to grease the wheels of the financial markets, which must now tolerate deteriorating operating conditions. The Icelandic government has also announced a bond issue that is launched with the same objective. Though the Central Bank does not wish to make too much of these changes, the purpose is to pave the way for easier operation of the financial system during at time of difficulty on the global front. But at the same time as these changes were reported, the Bank announced the Board of Governors' decision to raise the policy interest rate by 1.25 percentage points – to 15% – the largest single increase to date. That decision was the tangible manifestation of the serious message that the Bank considered it appropriate and necessary to communicate under the current conditions. The Board of Governors supported this decision by showing that the four-month-old inflation forecasts assuming an unchanged policy rate until the latter half of 2008 were not delivering the intended results. Inflation was higher than forecasts had projected, and inflation expectations were rising as well. In the same manner, demand was greater despite the more difficult operating environment faced by the banking system and the announcement that the credit supply was on the wane. The króna also depreciated more than was assumed in the forecasts in the November issue of Monetary Bulletin. That forecast assumed that such a development would be met with a policy rate hike, and though such forecasts are in no way binding for the Board of Governors, the Board's message can be interpreted as implying a similar message. It pointed out that the real exchange rate of the króna was close to the lowest it has been in several decades. Such a low real exchange rate has never persisted for any length of time. The Board of Governors' policy statement said the following: "If the decrease does not reverse, it is clear that inflation will rise sharply, and persistent inflation will be imminent if nothing is done, with the accompanying upward spiral of prices, wages, and exchange rates against foreign currencies. The depreciation of the króna in recent weeks is also harmful to the balance sheets of indebted households and companies and undermines the stability of the financial system over the long term. Thus it is critical that the depreciation of the króna be reversed as soon as possible."

The market's response to the Board of Governors' decision was favourable, and that is well, but at this point it is not possible to assert whether this decision will generate the results the Board of Governors intended. The next edition of Monetary Bulletin, the Bank's principal publication on economic issues, is in the final preparatory stages and will be published on April 10. It will include an appraisal and forecasts by the Bank's experts as regards the current economic climate and the likely developments in the near future. Because this next issue of Monetary Bulletin is forthcoming in such a short time, I have chosen not to discuss current issues at length today, though it was tempting to do so.

The media discourse on the size of Iceland's foreign reserves and the strength of the Central Bank and the Icelandic government is often misleading. It is admitted that the Treasury is actually free of foreign debt and virtually debt-free domestically, if one takes into account its deposit balance in the Central Bank. The Bank's foreign reserves and equity have never been larger than they are today. However, it has been said that Iceland's banks have grown substantially, which makes the foreign reserves proportionally smaller. It is appropriate to remember that banks in Iceland, as elsewhere, are responsible for their own operations, and they must demonstrate prudence and sound risk management. According to the banks' own declarations, to which the Financial Supervisory Authority has not commented, their financing status is at least comparable to that of comparable foreign banks. Therefore, they need not rush into disadvantageous credit markets ahead of others. However, it cannot be denied that the Icelandic economy's total debt is too high, which can be traced to the decisions made by financial institutions and other companies in the market.

If the Central Bank's foreign reserves are compared with those of several countries outside the largest currency zones, it can be seen that, according to information from the International Monetary Fund, Iceland's reserves as a percentage of per capita income are equal to or greater than those in, for instance, Australia, Sweden, Canada, and New Zealand. In terms of importation of goods, Iceland's position is also excellent. Only New Zealand is stronger overall. In terms of importation of goods and services, Iceland is well above average. But if the foreign reserves are evaluated as a percentage of foreign debt, Iceland is relatively weak.

On behalf of the Board of Governors, I would like to take this opportunity to thank the many people and institutions whose representatives are here today for a very satisfying collaborative relationship.