Ingimundur Friðriksson: The Icelandic economy and financial system in April 2008

Presentation by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, at a meeting of the Board of Directors of the Norwegian Financial Supervisor, Kredittilsynet, Reykjavík, 24 April 2008.

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It is a great pleasure for me to have been invited to speak to the Board of Directors and management of the Norwegian Financial Supervisory Authority at its meeting in Reykjavík this week. There are good reasons for the Norwegian Supervisor to come into direct contact with both colleagues in the Icelandic Supervisory Authority and with leaders of financial institutions in general. Much has been written and said about the Icelandic economy and financial system of late, some of it accurate, some of it not so accurate. For the outsider, it may be difficult to separate the accurate from the inaccurate.

As requested, I will in my presentation give an overview of recent economic developments and prospects and then touch briefly on the Icelandic financial system.

Economic developments and prospects

As you know, Iceland is one of the highest income countries of the world and one with a highly developed infrastructure and institutional framework. You may also know that Iceland is prone to greater economic fluctuations than most or all highly developed economies. In the 1990's, the Icelandic economy was deregulated and liberalised and that process was largely completed with the full privatisation of the Icelandic commercial banks shortly after the turn of the century. The liberalisation of the economy did not reduce its characteristic fluctuations. We are now coming to the end of a period of very rapid expansion. It started back in 2003 when construction commenced of a large aluminium smelter in the eastern part of the country and an associated power plant. The overall size of this investment was equivalent to over 30% of GDP in 2003, the year that construction started. It therefore gave a very large boost to the Icelandic economy.

In the latter half of 2004, the Icelandic banks began to compete head on with the State Housing Finance Fund (HFF) which had traditionally been the main provider of mortgage loans to households. The banks' entry into the market was no doubt the result of the HFF's ambition to increase its market share in the provision of mortgage finance. The banks had normally provided only a limited share of mortgage finance. They were in that respect different from banks in many neighbouring countries which have traditionally provided mortgage loans and thus have a stable portfolio of such loans on their balance sheet. The entry of the banks into the market led to significant changes. Households could now borrow against collateral in their existing real estate, that is, they could take equity out of their investment. This they did with vigour. The overall result was that credit grew briskly, real estate prices rose rapidly and private consumption expanded sharply, leading to inflationary pressures and a widening current account deficit.

The third important factor that contributed to the overheating of the Icelandic economy was the reduction in both direct and indirect taxes which, in addition to relatively large increases in general pay, led to a rapid increase in real disposable incomes.

All of this happened during a period of an international liquidity glut and historically low interest rates which further facilitated domestic demand growth.

The expansion of private consumption and the investment in the aluminium production capacity and the related power sector led to a widening of the current account deficit. It

reached the equivalent of more than a quarter of GDP in 2006, a phenomenally large deficit both in Icelandic economic history and by international comparison. The part of the deficit that resulted from the investment in aluminium and power evaporates as construction is completed and exports of aluminium picked up as of late last year. However, the larger share of the deficit, which resulted from other domestic demand, will only subside as restrictive economic policies have their intended effects. The current account deficit fell towards 15% of GDP in 2007, it will remain more or less unchanged this year but fall further in 2009, aided by the depreciation of the króna which I will touch on later.

Needless to say, inflationary pressures emerged early in the expansion phase. The Central Bank began to tighten policy in the spring of 2004. Inflationary pressures mounted and, to make a long story short, the Central Bank raised its policy rate in successive steps up to the present level of 15.5%.

Since 2001, the framework for monetary policy is an inflation targeting one, the target being a 2½% 12-month rise in the CPI. The regime was introduced under trying conditions and inflation rose rapidly immediately after its adoption but fell subsequently and was close to or below the target for about a year and a half before picking up in 2004. It has remained above target since 2004 and the most recent measure of the 12-month increase in the CPI was 8.7%.

The reasons for inflation significantly exceeding the target are manifold. I have mentioned the shocks to the economy, the construction of aluminium and power plants, the radical change in the mortgage finance market, the reductions in direct and indirect taxes and ample and cheap foreign credit. Moreover, there was during this period a systematic failure to correctly assess in real time the underlying strength of the economy. This means, that when the Central Bank tightened policy in the early phase of the expansion, official statistics and indicators available at the time significantly underestimated the underlying strength of domestic demand. Thus, in retrospect, the Central Bank responded too slowly and modestly to the inflationary pressures that were building up. A second factor was that the transmission of monetary policy measures was insufficiently effective. The presence of the Housing Finance Fund in the mortgage market and its state guarantee distorted the market and hindered policy rate increases from being reflected in mortgage rates. Moreover, the Central Bank was not able to sufficiently affect expectations in the market with its decisions and pronouncements. This significantly changed in early 2007 when the Bank began, like the Central Banks of Norway and Sweden for example, to publish a future policy rate path. That change greatly improved the communication and transparency of monetary policy and significantly strengthened the transmission mechanism as policy rate decisions were much more effectively reflected through the maturity spectrum.

The Treasury has delivered surpluses over a number of years. They and the privatization proceeds from earlier years were used to retire debt, leaving the Treasury currently without debt in net terms. In fact, the Treasury earned net interest income in 2007. Its deposits in the Central Bank are currently equivalent to roughly 12% of GDP. Nevertheless, it is evident from developments over the last few years that fiscal policy was not sufficiently tight to aid monetary policy in containing inflation.

Domestic demand has been slow in responding to tightened monetary policy. The higher policy rate meant that the Icelandic króna became an attractive investment vehicle for foreign investors. International issuance of Icelandic krónur bonds commenced in 2005 with relatively lively issue activity – albeit fluctuating – into the early part of this year. It followed a pattern very similar to that experienced by New Zealand. Foreign investors have also entered the Icelandic market directly, both in domestic securities and bank deposits. This development kept the exchange rate of the króna relatively high and obviously above its long term equilibrium level. The Central Bank repeatedly stated that the króna would depreciate at some stage. The Bank's hope was that the economy would have cooled considerably down

before that happened in order to limit to the extent possible the pass-through of the effects of the depreciation into domestic prices.

One aspect of developments during the period of expansion was the abundance of liquidity in the international markets at very favourable rates which I mentioned earlier. It fuelled among other things the rapid expansion of Icelandic banks and business in general to other countries. This expansion was financed partly by own funds but more importantly by relatively cheap credit. Questions have been raised from time to time in other countries about where the money for Icelandic investment abroad came from. They need not to be raised because the answers are provided in the statistics. The gross debt of the Icelandic economy rose rapidly and according to the official statistics, compiled on the basis of internationally accepted standards, the net international investment position of Iceland was negative by 125% of GDP at the end of 2007. In assessing these numbers, one must keep in mind the extremely rapid increase in gross capital flows resulting from the internationalisation of the Icelandic economy, its business and financial system. This complicates the compilation of balance of payments statistics, in particular on factor income and factor expenditures, and on the stock of foreign assets. Official data shows foreign assets at market value where market prices are readily available. Otherwise, assets are recorded at their book value.

In an article in the Central Bank's most recent *Monetary Bulletin*[1], an attempt is made to estimate the market value of inward and outward foreign direct investment using methods developed in other countries. This is done by estimating the likely market value of assets that do not have a readily available market price. The result of the calculation is that rather than being negative by 120% of GDP, the international investment position was negative by less than 30% of GDP at the end of quarter III of 2007. The large difference stems not the least from the fact that assets of Icelanders abroad are much larger than those of foreigners in Iceland. The lower figure is not necessarily correct. However, it shows that there is an overriding likelihood that the large negative net international investment position of Iceland is exaggerated in the official statistics which are compiled in accordance with IMF standards.

The Icelandic economy is at crossroads. It is quite evident that the expansion of recent years is coming to an end. The forecast issued by the Central Bank on April 10 envisages a contraction of GDP in 2009 and 2010. The Ministry of Finance forecasts a milder and more short-lived contraction. It is mainly driven by a sharp reduction in private consumption, but cyclical swings in private consumption are a recurrent feature of Iceland's economic history. Even if GDP contracts on the scale forecast by the Central Bank in 2009 and 2010, average GDP growth in the period 2005 to 2010 will still be well above 2%. Given the characteristic fluctuations in the Icelandic economy, one must take a longer view of developments than just one year to get a picture of long-term trends. It is also important to keep in mind that the contraction of the economy is unavoidable if sustainable balance is to be restored following the extended period of overheating. Once that has been achieved, the economy will be very well set for a recovery of growth to a long-term sustainable trend. Iceland is in the enviable position of being endowed with rich renewable energy resources in the form of hydro and geothermal power in addition to renewable resources of the sea. With rising energy prices and concerns for the environment, Iceland's energy reserves become all the more valuable. In addition, Iceland has highly developed service sectors, including financial services and tourism, that will contribute to the recovery of activity following the adjustment of the economy.

I should add here that in addition to favourable demographics, Iceland has a largely fully funded pension system with total assets equivalent to over 130% of GDP. Thus, there is no fiscal overhang related to a slowly aging population.

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[1] Daníel Svavarsson: International investment position: market valuation and the effects of external changes. Central Bank of Iceland: Monetary Bulletin 2008/1.

Focusing again on developments this year, the attention of the outside observer is easily arrested by the depreciation of the króna. I mentioned earlier that it was overvalued for a rather extended period to the extent that the Central Bank warned that it would at some stage have to depreciate. The depreciation came earlier and faster than we would have hoped, partly and perhaps most importantly because of the radical changes in global financial markets after the middle of last year and the associated reassessment of risk. These changes meant that the access of Icelandic banks to foreign financing was seriously curtailed. Additionally, questions were raised about the viability of the Icelandic economy in light of the large imbalances and all of this led to an erosion of confidence. Subsequently, the exchange rate depreciated significantly. By the end of March it had fallen to a historically low level in real terms, a level that was clearly below its long-term equilibrium value. The Central Bank responded to the developments in March by raising its policy rate by 125 basis points on Tuesday morning after Easter, followed by a further 50 basis points increase on April 10, bringing the policy rate to the 15.5% which I have already mentioned.

The policy rate action after Easter halted the slide of the króna and it has remained in a range above the low level it touched in late March. The sudden depreciation in the early part of the year greatly worsened inflation prospects. The rate of inflation is set to rise to above 10% in the near term before subsiding again. Given the policy rate path that the Central Bank published on April 10, the inflation target of 2½% will be achieved in the second half of 2010. The policy rate path also shows that given present prospects the Bank can begin to reduce its policy rate before the end of this year. All of this is covered in detail in the latest issue of the Central Bank's *Monetary Bulletin*[2].

Just as in other equity markets, stocks on the Iceland stock exchange have fallen in price from their peak in mid 2007. The decline in the Icelandic index is more pronounced than in many other countries largely because the relatively heavy weight of financial companies in the Icelandic index. Financial companies have declined more in price on the world stock markets than other companies on average. The stocks of Icelandic banks have not fallen more over the past year than those of many banks in neighbouring countries and big international banks, in some cases by less or even much less.

To conclude on the economy, in its monetary policy statement issued on the occasion of the latest policy rate decision on April 10, the Board of Governors once again stated that the Bank's most critical task was to reach the inflation target as soon as possible. The demand shocks of the past few years and unusual conditions in the global financial markets had delayed that process. There was no reason to surrender any ground in the battle against inflation. Thus the Central Bank continues to be fully committed to the inflation target.

Financial sector

You are familiar with the expansion of Icelandic banks to other countries, including Norway. This development followed the banks' full privatization a few years ago. The three major banks all expanded their activities to other countries but followed different strategies. The record shows that their investment in financial services companies abroad was generally very sound. They have good and solid operations in other countries. Because of this development, the banks have become less Icelandic and more Northern-European, as demonstrated among other things by the fact that in 2007 the three biggest commercial banks derived more than half of their overall income from activities outside Iceland and the biggest bank derived about two thirds of its income from operations outside Iceland. They are therefore much less sensitive to cyclical developments in Iceland than before, or in any one country for that matter. The risks are much better spread than before.

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[2] Central Bank of Iceland: *Monetary Bulletin* 2008/1.

In their expansion, the banks exploited the particularly favourable opportunities offered in the global financial markets in the form of abundant liquidity at historically very low prices. Thus, they relied on capital markets funding for their operations, raising the share of borrowed funds on the liability side of the balance sheet.

The rapid expansion of the banks did not go unnoticed. It drew the attention of many observers at the end of 2005 and the early part of 2006, resulting in considerable headwind for the banks in that period. Questions were raised about their business model, their reliance on wholesale funding in international markets and low level of deposits, lack of transparency and cross ownership among other things. The banks responded effectively to the criticism levelled at them. They increased transparency, reduced cross ownership, and placed emphasis on raising the share of deposit on their funding side. They also significantly strengthened their capital base and last but not least greatly improved their liquidity position. As a result they were much better prepared for the sudden change in global financial conditions after the middle of last year. Most importantly, they had a strong liquidity cushion.

The Icelandic banks have been the focus of considerable international attention in recent months. Questions have been raised about their viability and those have been reflected in their extraordinarily high CDS spreads since late last year. These spreads began to rise following the turnaround in the international markets and they had a tendency to rise more on the Icelandic banks than on other banks with every event or news that prompted a general rise in risk aversion and in CDS spreads. The spreads peaked around the end of March and have come down quite considerably this month.

The CDS market is an opaque and unregulated one but, nevertheless, CDS spreads are a reference for the terms that would be available to the banks if they were to go to the market. In our view, the CDS levels on the Icelandic banks have been out of proportion to their underlying financial strength, their credit rating and spreads on comparable banks in other countries. It also seems that the CDS market is thin, turnover in CDS transactions on Icelandic banks appears to be limited. One reason behind relatively high CDS spreads on Icelandic banks maybe the fact that a sizeable amount of Icelandic bank bonds issued in recent years ended up in CDO´s which have been in a process of being unwound over the last few months. However, this alone does not explain the very high spreads.

It is also quite remarkable that the CDS spread on the Republic of Iceland rose very substantially, even to 400 to 500 points when it was at its highest earlier this year. This happened despite the fact that on a net basis, the Icelandic Government has no external debt. It could thus acquire very significant external debt before reaching debt levels of many other developed countries with strong credit ratings. These CDS spreads have also come down significantly from their peak.

Despite the very high CDS spreads on the Icelandic banks, they have funds at levels that are below their CDS spreads. Nevertheless, the access of the banks to external financing has been limited. Their liquidity cushion means that they can stay out of the market for quite some time. The prevailing circumstances in international capital markets and the limited prospects of improvement in the foreseeable future have, however, led the banks to embark upon a process of reducing costs and streamlining their operations, including liquidating assets, and on attracting deposits. This is a process that evidently will have to continue. It does not detract from the fact that the banks had solid capital and liquidity positions at the end of last year as reflected in their 2007 accounts. They had a solid performance in 2007. They all returned a profit in the last quarter of the year despite the significantly more hostile operating environment. It was also notable that the profitability of their core operations was strong in that quarter. Taken together, the banks had insignificant exposure in sub-prime related instruments and where they existed, they have been significantly reduced. Thus, there have been small write-downs of sub-prime related debt as there has been little to write down.

Within the next couple of weeks, the banks will report their results for the first quarter of 2008. I have no information on what they will show. I can only say that the strong performance of their core business in the last quarter of 2007 allows one to anticipate a relatively good performance also in the first quarter of this year. In addition, given the composition of their balance sheet, they will all have profited from the depreciation of the Icelandic króna in the first quarter of the year as well as from the increase in the rate of inflation as they hold more price indexed assets on their balance sheet than indexed debt.

You are of course familiar with the regulatory and supervisory framework in Iceland. It is based on best international practice and has received high marks from foreign observers. The Supervisory Authority and the Central Bank cooperate closely on their respective roles in the area of financial stability. Developments over the last few months have increased the intensity of the cooperation and monitoring of developments in the institutions' respective fields of responsibility and experience. This is as it should be and in line what has been done elsewhere.

Like many other central banks, the Central Bank of Iceland has somewhat relaxed its rules on eligible collaterals under its regular liquidity facilities. These are broadly based on ECB rules, but ours are probably still somewhat more restrictive than the ECB's. The Icelandic interbank market has operated smoothly with rates consistently staying comfortably within the interest rate corridor of the Central Bank. The Bank has also modified other rules towards ECB standards, including the rules on reserve requirements.

The evolution of our financial system over the coming months and years will of course be very much affected by developments in the global financial system. Once conditions improve generally at the world level and the access of banks to financing improves, the most creditworthy banks will be at the head of the queue but others further back. Thus, it will take longer for Icelandic and other banks closer to the fringes of the international financial system to gain normal access to international financing. This is the scenario which the managements of banks will have to adjust their thinking, strategies and operations to. If they do that, I am sure that they will fare well. If they don't, their business will be more difficult.

The business of banking is much dependent on confidence. It is therefore of the utmost importance for the Icelandic banks and others to do everything that they can to strengthen confidence in their operations and not to postpone any measures to that effect in the misguided hope that the operating environment will recover soon.

In conclusion, I would like to mention that on May 8 the Central Bank of Iceland will publish its 2008 report on financial stability. It will be available on the Bank's website on that day. Our stability reports have been judged to be of high quality, transparent and frank. We intend to live up to that reputation once again.