Már Guðmundsson: Iceland's economy and monetary regime – a series of crossroads

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the 50th Annual General Meeting of the Central Bank of Iceland, Reykjavík, 7 April 2011.

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Honourable President; Prime Minister; other Ministers; Speaker of Parliament; Chairman of the Board; Party Chairmen, Bank Directors; Directors of Public Institutions; Ladies and Gentlemen:

This year's Annual General Meeting of the Central Bank of Iceland is held on the Bank's 50th anniversary. But it would hardly be accurate to say that the Bank is facing halcyon days at this milestone. Quite the contrary: times are turbulent. Furthermore, Iceland's economy and monetary regime are standing at a complex series of crossroads, and the paths we choose could have a profound impact on future developments. This is reminiscent of the situation that reigned when the Bank was founded, but I will come to that later.

What exactly are these crossroads, then?

The first fork in the road lies in the changing economic situation. Instability and recession are giving way to better equilibrium and recovery. The current account deficit from Iceland's overheating period has been turned around to an underlying surplus that has supported the króna, which is now over 7½% stronger than it was at the beginning of last year. At the same time, the Central Bank has bought foreign currency in the market for about 33 b.kr., as part of its plan to accumulate non-borrowed reserves. Inflation reached the Central Bank's inflation target towards the end of last year, due to a stronger currency, spare capacity in the economy, and inflation expectations approaching the target. This development is not independent of the monetary policy stance, however, as spare capacity can be associated with a vicious cycle of falling exchange rate and rising inflation expectations if confidence is lacking.

Indicators suggest that a weak economic recovery began in the third quarter of 2010, and forecasts assume that it will continue this year. The recovery is still weak, not least given the substantial slack in the economy. Two points of concern in this connection are that business investment is very low in historical context and export growth is rather weak in view of the low real exchange rate and robust recovery of global trade. An important factor here is that Iceland's major export sectors face capacity constraints; therefore, exports cannot be increased to any significant degree without further investment. Growth is strong in export sectors without such limits, but their share in total exports is still small.

The next crossroads stems from the vast improvement in Iceland's foreign liquidity and the build-up of the foreign exchange reserves. As of the end of February, the reserves totalled 719 b.kr., or 46% of GDP. Iceland's foreign reserves have never been larger as a share of GDP, not even at the end of World War II. Increased reserves, enhanced stability, progress in the implementation of the plan to achieve a fiscal surplus in coming years, and buybacks of Treasury foreign debt in the secondary market have silenced the voices that prognosticated sovereign default. These factors contribute to the assessment that it is now considered safe to start removing capital controls on outflows and that the conditions have improved markedly for Treasury foreign borrowing, which could pave the way for other domestic entities.

The Icesave referendum taking place this coming weekend could, of course, affect these prospects. If the "yes" vote carries the day, plans for capital account liberalisation and Treasury borrowing will proceed as currently planned. If the Icesave agreement is rejected, however, there are indications that two major credit rating agencies will decide to downgrade

Iceland's sovereign debt to sub-investment grade. This would impede foreign borrowing and delay capital account liberalisation, although it is not clear how strong or persistent these effects would be.

The financial system is at a crossroads as well. The first phase of financial system reconstruction is largely complete. Iceland's banks have defined balance sheets, private sector debt restructuring is underway, and changes have been made in order to address the most obvious flaws in the regulatory framework governing domestic financial institutions. A number of tasks remain unfinished, however, as regards establishing a stable, effective financial system. It is not yet possible to state with certainty that financial institutions could fund themselves without the support of capital controls and the declaration of a blanket deposit guarantee. In this context, it is critical to enhance the functioning of the financial markets, which are important for trading, funding, and risk diversification – particularly the foreign exchange and equity markets. It is also essential that financial institutions and other entities re-establish their access to foreign credit markets. A further task is to formulate policy regarding the nature, size, and international relations of the Icelandic financial system. It is no less important to formulate policy concerning the tools and institutional structure for financial stability: the financial crisis has taught us that assessing systemic risk is key, as are sound arrangements for the application of tools to mitigate it.

The final crossroads is faced by economic policy, as a result of the changes I have described. In short, it can be said that the tasks at hand are shifting from the achievement of stability to promoting growth, and from crisis management to longer-term development.

In terms of monetary policy, this can be seen in the Monetary Policy Committee's shift of its bias from monetary easing to neutral. This does not mean that interest rates cannot be lowered further, but it does mean that because inflation appears to have hit bottom, economic recovery has begun, and the effective policy rate is closer to equilibrium than before, it is not as clear what direction upcoming interest rate decisions will take. The next steps will be determined more by the newest indicators of economic developments and prospects than they have been in the recent past.

At its next meeting, the Monetary Policy Committee will probably assess whether and how the Icesave referendum results and the newly published capital account liberalisation strategy will affect monetary policy in the near future. The strategy divides liberalisation into two main phases, with Phase I dedicated to unwinding offshore króna positions by allowing owners to exit through auctions or by investing in the Icelandic economy. Only when these measures have generated acceptable results can controls on residents' capital outflows be lifted. If conditions are right, the latter phase could proceed relatively quickly, but if not, it will be executed more gradually.

It is difficult to say how long Phase I will take, as its duration will depend on a number of uncertainties, such as access to foreign credit markets. But it is important for near-term monetary policy that Phase I be designed to minimise potential negative effects on the exchange rate and the foreign exchange reserves, at least at first. It is only in Phase II that the interest rate differential with other countries begins to assume much greater importance as regards exchange rate developments.

In the recent past, monetary policy has been an element in the larger economic policy formulated by the Icelandic authorities in co-operation with the International Monetary Fund. The key features of that policy have been exchange rate stability, fiscal sustainability, and financial system reconstruction. In spite of delays in execution, the programme has, on the whole, been very successful. Our collaboration with the IMF according to the current economic programme will conclude in August, but of course, our long-standing co-operative relationship with the Fund will not end then. On behalf of the Central Bank, I would like to use this opportunity to thank the IMF and its staff for their efforts over the past two-and-a-half years. The conclusion of the IMF-supported programme and the implementation of the capital account liberalisation strategy bring the determination of Iceland's future monetary and economic policy framework to the fore. That work has already begun, partly with the Central Bank's December 2010 report entitled *Monetary Policy in Iceland after Capital Controls*.

Let us think back for a moment to 1961, when the Central Bank of Iceland first opened its doors. As will be described in subsequent speeches, the Icelandic economy was changing rapidly at that time. A number of structural changes were well underway, and some of them are still in effect today. The policy of the time aimed at establishing market-based economic equilibrium in Iceland. Trade in goods and services was liberalised, and multiple exchange rates were supplanted by an exchange rate based on underlying economic conditions. Then, as now, Iceland was pursuing an economic programme in collaboration with the IMF. Then, as now, Iceland's economic ties to the rest of the world were under review.

The establishment of the Central Bank was an element in these changes, and its activities were part of broader-based measures. From the outset, the Central Bank's position was strong. It is remarkable that among us here today are a number of people who were important thinkers and agents of change at that time.

Honoured guests: As I mentioned earlier, we are faced at present with the need to formulate future monetary and financial stability policies. The review of the Act on the Central Bank of Iceland will presumably be a part of that process. The Central Bank will participate actively in this work, but many others will be involved, and the Bank looks forward to collaborating with them. Ultimately, however, it is Parliament, and in some instances the people themselves, who have the last word.

In closing, I would like to thank the Central Bank's many collaborators for a successful co-operative relationship over the past year. I want no less to thank the employees of the Central Bank for their tireless efforts, for without their contribution, the Bank's work would bear very little fruit. And in closing, I want to express my gratitude to the many individuals who have put their shoulders to the wheel at the Central Bank of Iceland over the past 50 years. It is a pleasure to see so many of you here today.