Már Guðmundsson: Iceland – recent economic developments, conditions and outlook

Keynote address by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the 51st Annual General Meeting of the Central Bank of Iceland, Reykjavik, 29 March 2012.

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Prime Minister; Minister of Finance; Chairman; Directors and Ambassadors; Ladies and Gentlemen:

As we convene for the 51st Annual General Meeting of the Central Bank of Iceland, the economic recovery that began late in 2010 is gaining momentum in spite of international headwinds, while inflation has been higher and more persistent than was considered likely last year. It is important, too, to note that inflation is driven much more strongly by domestic factors than it was around this time last year, with wages rising in excess of increases in productivity and the nominal exchange rate declining in the recent term.

According to preliminary estimates, GDP grew by 3.1% in 2011. In international terms, this compares well, as output growth in the OECD averaged 2% last year. However, it should be borne in mind that the economic recovery began later in Iceland than in most OECD countries. Business investment and private consumption contributed equally to growth, about 2 percentage points each. The contribution from factors was negative, however. This growth was not borrowed, either: last year's underlying current account surplus measured roughly 3% of GDP.

In some respects, the composition of last year's output growth lays a sound foundation for continued economic recovery. Growth in business investment is an important factor, contributing over 25% in 2011. Business investment measured 9½% of GDP during the year. This is somewhat below the 30-year pre-crisis average of 13%, but the good news is that in Q4 the ratio of business investment to GDP was up to 12.2%. Of course, business investment should rise up above the average in a conventional upswing. But our upswing, as that of most other countries hit hard by the financial crisis, is not conventional. Iceland suffered a deep banking and currency crisis in 2008. Research shows that the contraction following such a twin crisis is usually deeper and more protracted than a contraction following either one of these crises. In addition, research shows that the economic recovery following a financial crisis is generally weaker than after a normal recession, as domestic debt levels are high. And finally, studies show that the post-crisis recovery of investment is usually slower than usual if the investment level was high before the crisis struck. All of these factors apply to Iceland and should be borne in mind in any discussion of the strength and pace of the economic recovery.

The labour market has developed broadly in line with the business cycle and the historical experience of Iceland and other countries. During the downswing, firms appeared to have tried to avoid layoffs, opting instead to reduce the number of hours worked and step up part-time employment. The turnaround in the labour market usually occurs somewhat later than the turnaround in general economic activity, emerging first in an increase in hours worked rather than in job creation. This is illustrated clearly in recent statistics. In recent months, however, there have been indications that this process has come to an end and job creation is on the rise.

In August 2011, the Central Bank forecast that inflation would rise sharply in coming months, peaking at about 6.8% in the first quarter of this year. This forecast, together with the assessment that the economic recovery was strong enough in spite of international headwinds to withstand modest interest rate hikes, lay behind the Bank's decision to raise interest rates last year. The consumer price index for March was published yesterday. It shows that inflation measured 6.4% in Q1, driven primarily by a wide range of increases: in public and private services, housing costs, petrol, and other imported goods. Core inflation is also high, at 6%.

The past few months' depreciation of the króna plays a role in the recent rise in inflation. In small, open economies like Iceland, the exchange rate is a key factor in the inflation process. In the long run, however, inflation cannot be explained solely as a function of nominal exchange rate movements, as it reflects, on the one hand, rises in wages and prices in excess of those in other countries and, on the other, changes in the real exchange rate, which stem from developments in underlying economic conditions such as terms of trade. Inflation that remains above target levels for a protracted period can only be explained by weaknesses in economic structure and policy, particularly monetary policy. In the short run, however, under- or overshooting of the nominal exchange rate can cause swings in the inflation rate, particularly if inflation expectations are poorly anchored to the target and exchange rate movements are significant.

In trade-weighted terms, the króna has fallen by 5.8% year-to-date and just over 7½% since November, when it last peaked. The depreciation seems to stem from several causes. It appears that net foreign currency inflows from trade in goods and services have been at a low ebb in recent months. While seasonal factors are at play here, it could also be that foreign currency subject to repatriation requirements is not being returned to Iceland in full. This situation is being investigated by the Bank's Capital Controls Surveillance Unit. In addition, firms and municipalities have been paying down foreign debt. In many instances, they are forced to do so, as they have no access to refinancing from abroad and would otherwise default on these loans. But there are also signs that interest rates in Iceland are low enough relative to corporate inflation and exchange rate expectations that some firms consider it in their best interests to convert foreign loans to domestic currency, which could be positive in the long run but puts pressure on the króna at present. This is one example of how the domestic interest rate level can affect the exchange rate in spite of the capital controls. Finally, recent exemptions from the capital controls, which the Bank has granted in cases where the exemptions were important for the growth and performance of the firms concerned and benefit the Icelandic economy in the long term, have affected the foreign exchange market in recent weeks. In some instances, these exemptions have triggered short-term outflows, even though they may generate increased foreign exchange revenues in the future. This is why the Central Bank intervened in the foreign exchange market earlier this month.

Judging from recent public discussion, it appears to be a commonly held misconception that a currency depreciation within a capital controls regime is in itself a sign of a major problem. The króna can – and should – fluctuate within the capital controls, even if they work perfectly. Trade in goods and services is unrestricted, firms and institutions are free to service their foreign debt, and all capital and the resulting outflows are unhindered. And all of these variables can fluctuate. The main aim of the capital controls is to stop uncontrolled currency outflows related to capital account transactions. But the controls affect the exchange rate of the króna and should do so. By all available measures and in international comparison, the króna has fluctuated less since the controls were imposed than it did over a long period prior to the banking and currency crisis.

I have discussed recent economic developments and conditions, but what about the outlook? According to the Bank's February forecast, output growth is expected to measure 2½% in 2012 and roughly the same in the following two years. If this forecast materialises, unemployment will decline gradually over the period, to about 5% in 2014, by which time the slack in the economy is expected to have disappeared. An underlying current account surplus is expected throughout the forecast horizon. According to the forecast, inflation will subside over the course of 2012, approaching the target in 2013 and aligning with it in 2014. These projections are dependent on a number of factors, however, specifically the exchange rate, which is currently below the levels assumed in the forecast.

As so often before, the economic outlook is uncertain, not least because of the global situation. The most recent indicators of private consumption and economic activity in the first quarter are broadly in line with the forecast, and perhaps a bit better. On the other hand, the short-term inflation outlook has deteriorated, and it could take a longer time than previously expected to bring inflation back to target unless the króna appreciates in coming months. According to the forecast, business investment as a share of GDP will be below the historical average throughout the forecast horizon, but the most recent developments, which I mentioned a moment ago, and the process of channelling offshore krónur towards investment could change that somewhat. The outlook for output growth and employment would improve even more, however, if business investment proved stronger.

The global economic outlook was very bleak towards the end of 2011, particularly in the euro area. The picture has changed, however, in the first months of 2012. International measures of risk aversion have declined more or less steadily since the winter began. Risk premia on debt-ridden euro area countries have fallen since the European Central Bank offered the banks three-year loans at low interest rates, action has been taken to address the debt problems facing individual countries, and moves have been made to improve the ground rules for the future. This does not mean that the flaws in the design of the eurozone have now been permanently fixed. Nonetheless, there are indications that the contraction in the euro area is easing, and other parts of the world are doing better than expected. In essence, the global economy is continuing to grow, and growth could begin anew in the euro area in the second half of this year. But the outlook is uncertain, and the global economic situation is fragile. In this context, we should bear in mind that while Iceland's performance in 2011 was good in spite of heavy weather globally in the latter half of the year, it is a small country and cannot remain insulated from international economic developments for long.

Monetary policy has been under discussion recently, as it has often been before, and opinion is divided on its optimum stance. There was a turning point in August, when the Central Bank published its forecast that inflation would rise strongly in ensuing months and peak in Q1/2012. It was also projected that Iceland's economic recovery would continue and that the difficult situation globally would not necessarily intensify enough to derail it. This outlook lay behind the Monetary Policy Committee's decision to raise Central Bank interest rates by 0.25 percentage points and indicate further increases ahead, which materialised in November and again this March. Another underlying factor was that the real policy rate had fallen considerably in the weeks beforehand. These decisions and the analysis on which they were based have proven correct. The economic recovery gained momentum, and it tolerated turbulence from abroad and modest rate hikes at home, which did little more than prevent the real policy rate from becoming even more negative.

The Bank's rate increases were very controversial at first, but the discussion has become less heated as the underlying analysis has been shown to be correct. At present, criticism is coming from both directions, and many critics maintain that interest rates are lagging behind developments in inflation and economic recovery. Whether this is true will come clear in the next few months, and if it is, remedial action will be taken. At its March meeting, the Monetary Policy Committee stated that further nominal rate increases were likely in coming months but that the scope of such action would depend on near-term developments in inflation and the exchange rate. Further ahead, it will be necessary to reduce the slack in monetary policy as the slack in the economy diminishes. The degree to which this takes place through higher nominal Central Bank rates will depend on future inflation developments.

In order to understand current monetary policy, it is necessary to place it in the larger context of post-crisis adjustment and recovery. In a sense, it can be said that the inflation that has plagued Iceland since the crash is a three-fold phenomenon. First of all, it stemmed from the currency depreciation that was part of the economic adjustment that inevitably followed the overheating of 2005–2007 and the subsequent financial crisis. Monetary policy should not have quelled it, nor could it have done so. The real challenge as I mentioned in my speech at the Annual General Meeting of 2010, was to allow the adjustment to take place without permitting inflation or unemployment to become entrenched afterward. Second, inflation rose temporarily as a result of rising global oil and commodity prices. Monetary policy should not react to these either – and it didn't. On the other hand, it is the task of monetary policy to prevent such increases from turning into a persistent inflation episode through a reaction of wages and other domestic cost factors. It is the third type of inflation that is a home-grown product. In increasing measure, the current bout of inflation falls into this category, as can be seen in the wage increases of the past year. Monetary policy must take action to impede this type of inflation, particularly when inflation expectations are well above target, as they currently are.

A key question in this regard is why this inflation episode has occurred in spite of unemployment figures and other measures suggesting a considerable slack in the economy. Of course, a number of explanations are possible: that there is a lack of confidence in the will and ability to apply policy tools as needed to attain the inflation target; that the tradable sector, which enjoys good operating conditions due to the low exchange rate, is a driver of wage developments; and that the exchange rate is temporarily low because of the repayment of foreign debt, which is to some extent forced and is occurring more rapidly than is desirable. It is interesting, too, to ponder whether the slack in the economy is actually smaller than current assessments indicate. This question is one that the Central Bank and the Monetary Policy Committee must grapple with at all times.

In the recent term, monetary policy has been conditioned by the private sector debt crisis, which stems from years of overheating and the subsequent financial crisis. As the debt situation improves and the slack in the economy diminishes, it will become more important to tackle inflation aggressively. Historical and international experience shows that this cannot be done without temporary sacrifices in economic activity and employment levels. We must therefore hope that inflation subsides as forecast in the near future.

Lifting the restrictions on capital outflows is one of the most complex tasks facing the Icelandic authorities at present. The controls probably prevented further depreciation of the króna after the banks collapsed, although no one knows how long the depreciation would have persisted. The controls therefore provided shelter for restructuring of private sector debt and the financial system as a whole and afforded monetary policy the room to concentrate more on domestic economic conditions than would otherwise have been possible.

The benefits of the capital controls are most pronounced during the resolution of the balance of payments problems proceeding from the collapse of the financial system. If all non-residents' so-called impatient claims on residents were paid in a short period of time, Iceland would pay down foreign debt much more rapidly than is desirable. If worse comes to worst, the deleveraging could amount to roughly half Iceland's GDP in relatively few years. In such a scenario, the króna would depreciate sharply, at least over a considerably long period of time, undermining banking system liquidity and public sector finances and making domestic and foreign Treasury financing much more expensive and difficult.

In this context, it is appropriate to emphasise that Iceland is facing a balance of payments problem and not a debt problem. Its gross debt currently amounts to 224% of GDP, and net debt is 52% of GDP, excluding the debt of the failed banks. The underlying debt position is much stronger, however. Estimates prepared by Bank staff a year ago suggest that once the old banks' estates have been settled and the air has cleared, gross debt will total 230–240% of GDP, and net debt, based on the estimated financial statements of the old banks will be about 60–80%. If the effects of one company's subordinated debt to its owners are excluded, net debt declines by another 40–50% of GDP. These estimates are subject to considerable uncertainty. The figures are currently being revised to take account of the most recent data, but there is a strong likelihood that Iceland's underlying debt will be roughly the levels seen at the turn of the century when all is said and done. The problem is that too large a share of it is short-term debt and without a negotiation process. The capital controls are intended to provide the space and negotiating position needed to address this situation. In this context, it is important that payments from the estates of the failed banks are no longer exempt from the provisions of the Foreign Exchange Act restricting cross-border movement of capital. Structuring the resolution of and disbursements from the estates makes it possible to prevent them from causing instability.

In the near future, the Bank will describe more fully how it intends to use its expanded powers to steer payments from the estates of the old banks. It is clear that asset recovery from the estates will not be affected. Furthermore, every attempt will be made to ensure that disbursements do not cause a balance of payments problem; however, payments that have no bearing on Iceland's balance of payments problem will be allowed to be disbursed as speedily as possible to creditors. This applies in particular to foreign-denominated claims on non-residents. Ultimately, it is in the best interests of Iceland and the failed banks' creditors to safeguard economic and financial stability, as is made plain by the fact that one of the creditors' largest assets is their stake in the new banks.

It is the authorities' duty to ensure that the capital controls are not a haven in which violators and circumventors can profit – and such profits can be substantial in some cases. These profits are not based on any value creation, nor do they fall from the skies like manna from Heaven. Far from it: these profits are obtained at the expense of those who either have no opportunity to circumvent the controls or who belong to the majority of people who abide by the law. The cost emerges in an excessively weak króna, elevated inflation, and higher interest rates. This is why it is so important to close the loophole entailed in cross-border transfer of payments on amortised bonds. It is also why the surveillance and investigation of the Bank's Capital Controls Surveillance Unit and the activities of the Special Prosecutor's Office are so important. Whether or not the capital controls should exist is, of course, a subject for debate, but while they do exist, not enforcing them to the maximum extent possible would simply be discriminatory.

In a broader context, I think it is useful to think of the capital controls as tools that provide short-term benefits related to economic and financial stability but have associated long-term costs due to trade restriction, and these costs grow over time. Untimely and poorly structured removal of the controls could jeopardise economic and financial stability and entail substantial short-term costs. Careful structuring of the liberalisation process will significantly reduce this risk, although it will not eliminate it. The problem is that we know the signs of these effects but not their magnitude. At present, there are no research findings on the costs associated with capital controls or how much those costs rise each year, as this is a complex estimation task that may not even be feasible until several years from now. On the other hand, it can be argued that the costs were small to begin with because of the situation represented by a worldwide financial crisis. Furthermore, in implementing the capital controls, the Central Bank has attempted to reduce these costs as much as possible by granting exemptions. A bill of legislation relaxing certain restrictions affecting firms and individuals is expected in the near future.

But none of this changes the need to make every effort to abolish the capital controls. I mentioned long-term costs. In addition to this, the controls were imposed as an emergency measure and constitute a deviation from our contractual obligations under the EEA Agreement. That deviation has been approved by our counterparties, but we are still obliged to make our best effort towards lifting the controls without jeopardising financial and economic stability. Does this mean we must revert all the way to the regime we had before the crisis? I think that, as regards corporate and household capital movements, the answer is broadly yes. On the other hand, it will be necessary to limit financial companies' exchange rate risk more than was done before the crisis, including the maturity mismatches in their balance sheets and overall size of foreign-denominated balance sheets. It will also be necessary to impose tight restrictions on foreign-denominated lending to households and businesses without corresponding foreign currency-linked income. But these restrictions are prudential rules rather than capital controls. The Central Bank sent the Minister of Economic

Affairs a report on this topic at the end of 2010 and intends to send him a more in-depth report on the same subject shortly after Easter.

Looking ahead to the next several years, the question is not whether we lift the controls, but how. This is not the time or place to go into that topic in detail, as it has been discussed recently in some depth by the Bank and its representatives, and that discussion will presumably continue. The main point is that carefully preparing the liberalisation process, as is currently being done, significantly reduces the risk to financial and economic stability. Progress has been made in this area, and a great deal more can be done in the near future. There is quite a bit at stake: the short-term benefits conferred by the capital controls could be lost at the eleventh hour and several years of long-term benefits of free capital movements could be burned up if liberalisation is carried out recklessly.

To that end, it is of key importance to move unstable offshore krónur out of the hands of those who cannot hold them and do not want them and into the hands of investors prepared to commit capital in Iceland for a long period of time. It is also important that the general conditions provided for in the liberalisation strategy be met as fully as possible, for this will reduce the risk of instability when the controls are lifted. These conditions include ample foreign exchange reserves, Treasury access to foreign credit markets, and a sound banking system that can fund its activities in an environment free of capital controls.

Great strides have been made in this respect, as can be seen in the Treasury's foreign bond issue last summer, the Bank's sizeable foreign exchange reserves, the prepayment of loans from the IMF and our Nordic neighbours, improvements in Iceland's sovereign credit rating, declines in Iceland's CDS spread, and the banks' sound capital position in spite of the court judgments handed down in cases involving exchange rate-linked loans. But it is also important that the Treasury's net domestic borrowing need be as small as possible once liberalisation begins, as it is probable that financing costs will rise sharply at that point in time. In this context, it is interesting to note that the Treasury's real domestic financing costs in 2011 were negative by roughly 0.7%. It is therefore vital to adhere closely to the plan to achieve an overall Treasury surplus in 2014.

Honoured guests: I have spent considerable time on economic developments and prospects, monetary policy, and the capital controls, as these are the topics of most importance to the Central Bank at present. But as the Minister of Economic Affairs said in his speech today, we are faced with formulating long-term policy concerning our currency, our monetary policy framework, our financial system structure, and the substance and institutional framework for our financial stability policy. Other opportunities to discuss the substance of these matters will present themselves in coming months. I would like to mention two points in the context, however. The first is that we must carry out these tasks very carefully and make good use of the time that we have. Some issues are more urgent than others, but in some areas the discourse is far from being fully developed, and the topics are in a state of flux in the international arena. This applies, for example, to the subject of how and to what extent separation is achieved between the financial system infrastructure and support systems that the Government will always try to keep functioning – such as payment intermediation and general depositors' access to their bank accounts – and leveraged speculation on the part of the banks' owners and customers. It also applies, but to a smaller degree, to the structure for monitoring and responses to risk in the financial system as a whole. The danger is that, if we do not proceed with due care, hurried decisions will be made that will be revealed to be poorly conceived the next time the financial system runs aground, which might not occur until decades from now. The other point I wish to make is that the Central Bank of Iceland will do its utmost to ensure that this policy-making process is carried out as meticulously as possible, and its staff have significant expertise on all of these issues. The Bank's next major contribution to this process will be an in-depth report on Iceland's options for a currency regime, which will be published this spring or early this summer.

Before I close, I would like to thank the Central Bank's many collaborators for a successful cooperative relationship over the past year. Particular thanks are due to the ministries with which the Bank works most closely: the Ministry of Economic Affairs and the Ministry of Finance, as well as the Prime Minister's Office and the Ministry for Foreign Affairs. I would also like to express my gratitude for the cooperation with the Parliament of Iceland, particularly the Economics and Commerce Committee. In addition, I wish to thank the Financial Supervisory Authority for successful collaboration in 2011, the first year of the new cooperation agreement between the two institutions. And last, but certainly not least, I would like to thank the staff of the Central Bank for their work during the year.

And in closing, I wish to say this: We have a tendency to give little thought to our important economic and societal infrastructure until it gives way. This is true of electricity and heat utilities, water and sewage systems, and matters such as payment intermediation. But fortunately, we have specialised groups of people who monitor such systems, and within the Central Bank and its subsidiary, Greiðsluveitan, is just such a group specialising in payment intermediation. The banking crisis put domestic payment intermediation to the test. The system passed that test, although banknote inventories were very slim at one point. Since then, significant work has been done to enhance payment intermediation security and to learn from the weaknesses that came to the fore during the crash. In 2011, changes were implemented in the banks', savings banks' and Central Bank's decades-long joint ownership and operation of payment intermediation infrastructure, which is now solely in the hands of the Central Bank. In addition to improvements in security, emphasis has been placed on enhancing transparency and disseminating information on payment intermediation. In part for this purpose, the Bank has issued two reports on payment card transactions: a report on credit card transactions, issued in 2011, and a recent report on debit card transactions. We hope that both of these reports will increase all stakeholders' knowledge and understanding of the payment card market and will highlight the items in need of improvement.

Although credit and debit cards are the most important means of payment among the general public, cash (banknotes and coin) is still an important payment instrument and has actually gained in importance in the recent term. For a long period, cash in circulation amounted to less than 1% of GDP, whereas it now totals roughly 2½%.

Price level developments and the increase in cash in circulation give cause to consider the need to issue a new banknote with a higher face value. The Central Bank has therefore begun preparing for the issue of a new 10,000 kr. banknote that will be equipped with better and more numerous security features than its predecessors. In appearance, the new note will be similar to the others in use, and the graphics will be related to the poet Jónas Hallgrímsson. The bill will also feature the plover. It is planned that the new banknote will be put into circulation in the autumn or early winter of 2013.

On this occasion, and because we are faced with a large array of complex tasks, as I have mentioned in my speech today, I think it is appropriate to close with a poem by Jónas Hallgrímsson, which I interpret to mean that challenges like those ahead of us certainly require organisation and forethought. We can only cross the river where it is possible to pass. But to make the crossing we also need determination and courage. In Jónas' words:

> *The cliffs on life's swift current*
> *are cleft by shallow valleys.*
> *Masses have queued to cross there ---*
> *crowds of billy-goat milkers.*
> *We'll go upstream, God willing,*
> *to walk the hawk-high ridges*
> *and pitch ourselves --- impetuous ---*
> *plumb in the roaring torrent!*
>
> ***Above the Ford (1845)***
>
> *English translation: Dick Ringler*