Már Guðmundsson: Recent economic and financial developments in Iceland

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the 54th Annual General Meeting of the Central Bank of Iceland, Reykjavík, 26 March 2015.

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Mr. President; Speaker of Parliament, Minister of Finance and Economic Affairs, Minister of the Interior, Directors, and Ambassadors; Ladies and Gentlemen:

We have come together today for the 54th Annual General Meeting of the Central Bank of Iceland. When we met for the Bank's Annual Meeting five years ago, the Icelandic economy was at the bottom of the economic recession that followed the financial crisis of 2008. The future was highly uncertain. Had the economy hit bottom? How strong would the upswing be? How much would the unemployment rate fall? Would we be able to bring inflation back to target and keep it there? How would the sizeable debt owed by Iceland's central government, households, firms, and the national economy evolve? How would the newly established domestic-oriented banks fare? Was Iceland's external position sustainable? When and how would we manage to lift the comprehensive capital controls that proved necessary during the crisis?

In my speech at that meeting five years ago, I listed three challenges that, in my view, the Icelandic authorities faced under the conditions then prevailing. What I said was this:

> *First, it is critical to allow the economy to adjust without allowing inflation or unemployment to become entrenched. The goal is a situation in which economic slack has disappeared, economic growth is in line with growth in potential output, inflation is at the target, and the external position of the economy is sustainable. Second, we must establish a financial system that serves Icelandic households and domestic business activities and is both efficient and relatively secure. The third challenge is that of re-establishing confidence abroad in Iceland's institutional framework, economy, and financial system; repairing the connections with foreign financial markets; and ensuring that the Icelandic Government and Icelandic companies have access to foreign credit markets once again.*

The economic recovery was just about to begin when the 2010 meeting was held. It then gained enough momentum that, in five years' time, we have returned to pre-crisis GDP levels and have eliminated virtually all of the spare capacity in the economy. At the same time, the unemployment rate has fallen sharply and is now close to its equilibrium value. Structural reforms could reduce the equilibrium unemployment rate still further in the future, however. Inflation is below the inflation target at present, and inflation expectations had subsided to target by the turn of the year. Treasury debt has declined steadily since 2011, and the outlook is for this trend to continue in the years to come. Household and corporate debt levels have also declined markedly. The ratio of household debt to disposable income is now roughly at 2005 levels, and the ratio of corporate debt to GDP is at its lowest since mid-2004.

Iceland's external position has proven to be sustainable. The trade surplus has been around 8% of GDP since 2009. This is the longest continuous period with a surplus over 5 % of GDP in the history of the data, which extend back to 1875. The current account balance as a whole has averaged 5.5% of GDP per year; that is, excluding the effects of the failed banks and other factors that do not reflect Iceland's financial burden. The current account balance has reduced Iceland's debt, cutting underlying net external debt almost in half since year-end 2008, to about 45% of GDP by the end of 2014. But all of this does not change the fact that Iceland still faces a balance of payments problem, which is reflected in the fact that a too large share of its debt is too short-term, and a part of the debt takes the form of possibly volatile ISK assets held by non-residents. This situation could put substantial pressure on the exchange rate or the Central Bank's foreign exchange reserves if these ISK assets were free to exit the country.

The three new commercial banks have also performed well in a number of areas, as can be seen in various indicators, including their capital ratios, which have risen from a 2009 average of 16% to last year's average of nearly 29%. The initial foreign currency mismatches in their balance sheets have been reduced are now within the limits provided for in Central Bank rules, and their domestic and foreign liquidity positions have improved. But the banks are operating in the shelter of the capital controls, and looking ahead, questions concerning their size and efficiency remain to some extent unanswered.

Many factors have been favourable for us in spite of global headwinds, which were initially reflected in a marked deterioration in terms of trade and are still reflected in a weak economic recovery among our trading partners. Looking back at the three challenges I mentioned a moment ago, we can say in broad terms that the macroeconomic goals have been met thus far. The financial system now stands on much more solid ground. It is primarily in connection with the third challenge, of reintegrating Iceland into international capital markets, that more work needs to be done. But even in this area we have made significant progress. GDP growth, a balanced economy, a Treasury surplus, and the Central Bank's foreign currency purchases have created good conditions for the liberalisation of the capital controls. The credit ratings of the sovereign and the commercial banks have improved. The sovereign regained access to foreign credit markets some time ago, and the banks have opened a crack in the door.

But even though we have made significant progress, the game is not yet won. Debt levels are high, rendering borrowers vulnerable to shocks, and the capital controls are still in place. Iceland's macroeconomic balance is good, but fragile. On this score, we face three relatively important risks: first, that the interactions between labour market unrest and the turnaround from output slack to a positive output gap could undermine price stability and turn the current account surplus into a deficit; second, that lifting the capital controls could turn out badly, with negative implications for exchange rate stability, inflation, and financial system stability; and third, that the global economic situation could turn against us. Therefore, we must avoid complacency, and we must be vigilant if we are to safeguard our recently achieved stability and face down the three challenges that I have mentioned just now.

In some respects, formulating monetary policy is complex at present, as it has been at times in the past. The Central Bank's interest rates were lowered by 0.75 percentage points in the final two months of 2014, in response to rapidly falling inflation and the decline of inflation expectations to the target. Since then, inflation has dropped still further, falling below 1% in December, triggering the submittal of a report to the Government on inflation below the deviation threshold.

Even though inflation is now below 1%, the Central Bank's key interest rate has been unchanged at 4.5% so far this year. There are a number of reasons for this. First of all, the extremely low inflation rate is due partly to the abrupt drop in global oil and commodity prices in the second half of 2014. This drop could prove temporary, but even if not, it is beyond the scope of domestic monetary policy. Furthermore, it can be assumed that real wages will rise if the decline in oil prices proves long-lived, but the impact on inflation will taper off. Second, the inflation outlook is clouded by various domestic uncertainties. The slack in the economy is turning around into a positive output gap. There is far more unrest in the labour market than might be expected in view of overall macroeconomic conditions and supply and demand in the labour market. In regards to the inflation outlook, the most important factor is that some groups have demanded extremely large pay increases that would set inflation in motion again and call for a strong monetary policy response if they extended to the labour market as a whole. The third reason is that inflation expectations, which had subsided to target at the beginning of the year, have risen again in recent weeks, probably due to the unrest in the labour market.

The labour market situation is both thought-provoking and a source of concern. Wage pressures that jeopardise the inflation target are generally interpreted as a sign of a positive output gap and excess labour demand, which call for a tighter monetary stance. Yet a number of factors indicate that this is not the main explanation for the current situation. Instead, it appears that the consensus on wage differentials has been weakened at the same time that opening of the labour market vis-à-vis abroad has put pressure on wage differentials – in some cases, in the direction opposite to that demanded by labour market organisations.

As Monetary Policy Committee member Gylfi Zoëga pointed out recently, the greater the sense of cohesion about wage distribution in society, the lower the unemployment rate that is consistent with low and stable inflation. Conversely, the weaker that sense of cohesion, the less individual worker groups will be willing to participate in creating the public good that is price stability, and the higher the equilibrium unemployment rate will have to be. This theory is based partly on the work of Ezio Tarantelli, one of Italy's leading economists in the second half of the twentieth century, which shows us that our experience is far from unique. If the theory applies to the current situation in Iceland – and a number of factors indicate that it does – increased cohesion in this sense could create the conditions for lower unemployment and lower interest rates, but without losing control of inflation.

Whatever the reason, this situation gives rise to the risk of an outcome that is worse for society as a whole, although some groups may gain at others' expense. In other words, in this situation as in so many others, a cooperative solution is usually better for the whole than a conflict solution. Therefore, it is extremely important that the parties involved – particularly the social partners and the Government – make every effort to push matters in that direction.

It is important that the decisions taken in wage negotiations over the next several months be based on correct information. The report published jointly by the social partners last month, entitled *In the Prelude to Wage Negotiations*, contains cogent information on wage developments in recent years. According to the report, the emphasis placed on the lowest wages in recent years has borne fruit, at least in part. For example, office workers' and general labourers' wages rose most during the period from 2006 through 2014, and they rose in excess of the general wage index. The report also confirms what has previously been reported, that wages and productivity per hour worked are relatively low in comparison with trading partner countries and that Icelandic workers compensate somewhat for this with longer working hours. This highlights the fact that, in the long run, increased productivity is the premise for higher real wages.

In this context, the weak productivity growth in recent years could give some cause for concern. On the other hand, it also reflects the growth of labour-intensive sectors such as tourism, which have been supported by the low real exchange rate and have facilitated a more rapid decline in unemployment than would otherwise have been possible. It also explains in part why unemployment among young people is – fortunately – much lower in Iceland than in many of our trading partners. When full employment is achieved, productivity growth will become more important, however.

If attempts to ease the tension in the labour market are unsuccessful and wages rise far more than is consistent with the inflation target, it will be unavoidable to respond by tightening the monetary stance; i.e., by raising interest rates. Even if inflation rises early on, the Monetary Policy Committee has the tools it needs to bring it back to target over the medium term. Higher interest rates will have a negative effect on GDP growth and employment over time, however. Real wages and the real exchange rate will rise because of the interactions between rising nominal wages and a tighter monetary stance. In addition, firms would probably respond by slowing down recruitment – perhaps even by cutting back on staff. There is the risk that such a turn of events would be most harmful to labour-intensive sectors and workers whose position in the labour market is weakest. It is therefore important to find ways to channel the desire to improve standards of living towards measures that are likely to generate more lasting results without jeopardising stability and the economic recovery that has brought us this far.

Honoured guests: The time for decisive steps towards lifting the capital controls is rapidly approaching. Some may think this step comes rather late. This is quite understandable. And there is no reason to soft-pedal the fact that the capital controls are harmful to the Icelandic economy. It is difficult to make a sufficiently accurate estimate of the magnitude of the negative effects, and I am not sure that the assessments made thus far would all stand up to close examination. One thing we do know, however: the detrimental effects escalate as time passes.

But we must understand the nature and scope of the problem if we are to make a reasonably fair assessment of the time that has passed and of how quickly the controls can be lifted.

In this context, I have found it helpful to explain to foreign observers that the collective collapse of Iceland's three large banks is thought be the third-largest bankruptcy in history. The Lehman bankruptcy was larger, and its settlement is not complete. Our own settlement is taking place in one of the smallest countries in the world and is associated with a severe balance of payments problem, whereas in the case of Lehman, balance of payments problems have relatively little relevance. Another point that I make is that if all of the estates' króna-denominated assets were added to the current stock of offshore krónur, the combined stock would increase to about half of GDP. Of course, we will not let that happen, but if it did, the new "overhang" would be much larger in proportional terms than the UK's post-war sterling overhang, which totalled nearly a third of its GDP. It took the British over four decades to lift the capital controls that were imposed partly for this reason.

The most usual way to describe the problem is to consider the capital that is likely to seek an exit as soon as the controls are lifted. This includes the failed banks' estates, the potentially volatile ISK assets held by non-residents – usually called offshore krónur – and possible outflows from Icelandic residents as well. In this context, we are best equipped to predict what would happen if the controls were lifted from the estates without any mitigating measures, as we have mapped out the estates in infinitesimal detail. There is greater uncertainty about the offshore krónur. Following the Bank's foreign currency auctions in the past few years, some of the remaining capital could be held by patient investors, as some of the parties behind it swear faithfully that it is. But it is safer to verify and secure this before we open the exit doors wide, and there are ways to do it.

The greatest uncertainty centres on potential outflows from residents. To a degree, it is possible to estimate resident investors' need to increase the share of foreign assets in their portfolios, but naturally, they may undertake such foreign investments at varying tempos. The most important factor either way is the level of confidence in Iceland and its financial system at the time the controls are lifted, which is obviously an unknown at this point. It will also be a major determinant of potential inflows from non-residents at the same time.

It is precisely one of the key factors in preparing for liberalisation to facilitate the recognition of Iceland as a sound, trustworthy investment option, and that resident investors – and not only the sovereign – have access to foreign credit markets on sustainable terms. Under current conditions, this means that we need an economy that is growing and is in equilibrium, both internally and externally. We need a Treasury surplus, and we need to reduce the Treasury debt ratio. We need strong enough national saving to support a normal investment level. Given the current outlook for investment, this means we must have a surplus on the current account of the balance of payments. We need large enough foreign exchange reserves to sustain the confidence of foreign lenders, maintain our credit ratings, and cushion us against volatility. We need a banking system that is solid and resilient.

As I mentioned earlier, we are doing well in many of these areas, and the conditions exist for further improvements during the current year. The extension of the maturity of Landsbankinn's debt to the old bank (LBI), which was finally negotiated towards the end of last year, has improved the situation. It enhances the possibility of expanding the foreign exchange reserves and increasing the portion not funded with foreign credit. In 2014, the Bank was a net purchaser of foreign currency in the amount of 111 b.kr. So far this year, it has bought currency for 30 b.kr., as opposed to 21 b.kr. over the same period in 2014. If it maintains that pace, it will buy more currency in 2015 than in 2014. As a result, the reserves exceed the outstanding foreign-denominated loans taken to finance them – by 65 b.kr. as of the end of February. But we mustn't rest on our laurels; we need sizeable reserves as we prepare to lift the capital controls.

I mentioned uncertainty surrounding the estimation of potential FX outflows once the controls are lifted. But one thing is certain: if the failed banks' estates were given a green light tomorrow and could convert all of their krónur to foreign currency, and the same happened with the offshore overhang, there is no way we could safeguard stability, let alone bolster confidence, except perhaps after a long time has elapsed. The Central Bank of Iceland has designed a model intended to assess the impact of various developments in the balance of payments over a long horizon, including capital account liberalisation measures. When applied to this instance, the model reveals that our entire foreign exchange reserves would be wiped out – and more besides – if they were used to shore up the exchange rate. This would never be done, of course, and therefore the currency would depreciate sharply. It is clear that if residents were free to exit at the same time, they would participate in the run on the currency, and confidence would evaporate quickly, leaving us with a new currency crisis to grapple with. Of course, this is an extreme scenario in some respects, as the estates' ISK assets, for instance, are not all liquid at this point in time, and a portion of the offshore krónur could be patient capital. But it gives an indication of the kind of problem we are dealing with.

Therefore, we need other solutions that safeguard stability and prevent additional burdens from being placed on the sovereign or the Icelandic people. Such solutions do exist, and a large group of experts – foreign consultants; the task force for capital account liberalisation, which works for the steering committee on the capital controls; and experts from the Central Bank and the Ministry of Finance and Economic Affairs – has been working hard on developing them in recent months. I would like to take a moment now and thank all of these people for their tireless efforts and excellent work.

It would be premature to publicise solutions at today's meeting. Moreover, it is not within my purview to do so on my own. The liberalisation of the capital controls is a collaborative project undertaken by the Central Bank and the Government, which actually means that elected representatives have the last word on the actions taken – particularly if and when tools are used that are not in the Bank's toolbox.

Honoured guests: I have spoken at some length on monetary policy and the labour market, on the one hand, and the capital controls, on the other. But I have done so with a purpose, as these are by far the greatest economic challenges facing us at the moment.

Yet the Central Bank's sphere of activity includes many other functions as well, not least those centring on the structure and stability of the financial system. Let us hope that, when we convene a year from now for the Central Bank of Iceland's 55th Annual General Meeting, we will have resolved successfully the urgent issues now facing us and can turn our attentions to these other areas of activity.

In the field of financial stability, emphasis has been on the risks related to the capital controls and on the formulation and implementation of the prudential rules that, in our opinion, must be in place once the controls are lifted. That work is well underway.

And as regards risk assessment and contingency planning, the Systemic Risk Committee and the Financial Stability Council will be meeting next month, and the Central Bank's *Financial Stability* report is scheduled for publication on 22 April.

Honoured guests: As the Chairman of the Supervisory Board mentioned in his speech, the Central Bank was relatively successful in working towards its goals in 2014. In addition, a great deal of work was done to ensure the efficacy of the capital controls, the smooth operation of financial system infrastructure, and the recovery of legacy assets from the crisis, among other things. This would not have been possible without the competent and hard-working people employed by the Bank. I wish to thank you all for your efforts. In this context, I would like to stress how important it is that, whatever amendments may be made to the Central Bank Act, the Bank must remain a strong institution capable of safeguarding monetary and financial stability in Iceland. In order to do so, it must have the independence to apply its policy instruments to this end. It must also be a professionally strong and vigorous workplace where senior management and staff members have a dynamic interactive relationship on matters relating to operations, analysis, and policy formulation.

In closing, I would like to thank the Central Bank's many collaborators for a successful cooperative relationship over the past year, in particular the Ministry of Finance and Economic Affairs and the Financial Supervisory Authority. I thank the financial institutions with which the Bank interacts for their cooperation. I would also like to thank the Parliament of Iceland, particularly the Economics and Commerce Committee, for their collaboration.