Már Guðmundsson: Recent economic and financial developments in Iceland

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the 55th Annual General Meeting of the Central Bank of Iceland, Reykjavík, 17 March 2016.

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Mr. President, Speaker of Parliament, Minister of Finance and Economic Affairs, directors, foreign ambassadors, ladies and gentlemen!

As we gather here for the 55th Annual General Meeting of the Central Bank of Iceland, the state of the economy is in many respects good. It is now the first quarter of 2016, and the current period of GDP growth has lasted since the second quarter of 2010, or six years. This quarter's GDP is estimated at over 4% above the pre-crisis peak. The slack in the economy has turned into a positive output gap, and we have full employment, at least.

Unlike many previous periods of full employment, the external and internal balance of the economy is still relatively good.

Last year's trade surplus amounted to 7% of GDP. It sufficed to cover the deficit in interest, dividend, and wage movements to and from the country (excluding the calculated interest on the old banks' estates), and the current account surplus thus measured was probably close to 5% of GDP. If this turns out to have been the case, there will have been an underlying current account surplus averaging over 5% of GDP each year since 2009. This has played a major role in the ongoing reduction in Iceland's foreign debt, as I will touch on later.

Inflation has been at or below target for two full years. This is the longest such period since inflation targeting was adopted 15 years ago this Easter. And it has happened in spite of steep wage increases, which under typical conditions would have generated much higher inflation. But it so happens that conditions are far from being typical. Iceland's terms of trade have improved markedly with the decline in oil and commodity prices, and tendencies towards deflation can be seen widely abroad. This has worked to counteract domestic inflationary pressures. At the same time, exports of goods and services have grown strongly, not least because of the booming tourism industry. According to newly published figures from Statistics Iceland, national income grew by nearly 8% in real terms in 2015, looking through the failed banks' estates. When national income is measured, GDP is adjusted for income that reverts to non-residents and for changes in terms of trade. This tells us more about purchasing power in the economy as a whole than GDP does, and it explains in part why the recent wage increases have thus far generated much more real wage growth than inflation.

There has been a substantial change recently in Iceland's net external debt. According to newly published figures, external debt amounted to 14½% of GDP at the end of 2015. One must go as far back as the herring boom of the 1960s to find a comparable debt position. The end-2015 external debt ratio was probably more noteworthy than it might otherwise have been because the net debt position as measured according to international standards was nearly three-and-a-half times GDP only a quarter earlier. That figure was highly misleading, however, because it included, at full price, all of the debt of the failed banks' estates, even though it had long since become clear that those debts would not be repaid except in part. For this reason, the Central Bank had adopted the practice of publishing what it called the underlying external position, which looked through the expected settlement of the estates. By this measure, Iceland's net debt totalled just over one-third of GDP at the end of Q3/2015, down from nearly one GDP at the end of 2008. Nearly 40% of the reduction is due to the current account surplus and GDP growth during the period, and the rest is due to default, debt restructuring, and other factors. The reduction in the debt position in Q4/2015, from 35% of GDP to 14½%, is due for the most part to the settlement of the failed banks' estates on the basis of stability conditions.

As can be discerned from what I have just said, the state of the Icelandic economy is quite good. According to current forecasts, the outlook is relatively good as well. According to the Central Bank's forecast from February, GDP growth will be robust in 2016 and above its historical average for the two years thereafter. This certainly entails an increase in the positive output gap this year, but that tension will subside as the forecast horizon progresses, owing in part to a tighter monetary stance. Inflation will also rise with a larger positive output gap and reduced deflationary pressures from abroad as the year progresses, but monetary policy will counteract it. According to the forecast, inflation will peak at just over 4% in 2017 and then taper off over the remainder of the forecast horizon. Unlike in many previous forecasts, the strong current account surplus will persist for the entire forecast period, which extends until 2018, in part because national saving will remain above the historical average.

In this context, we must bear in mind that things can change quite suddenly. It is also worth noting that numerical economic forecasts, by their very nature, have a tendency to be much more stable than historical reality. In the recent past, we have reaped the benefits of developments abroad, but we do not know how long this will last, and tailwinds could turn into headwinds. History also tells us that we have a tendency to make economic policy mistakes during booms and mistake temporary positive shocks for permanent improvements. If history repeats itself, domestic demand and inflation could increase more than is assumed in the forecast. We must therefore be vigilant and be careful when taking the decisions that lie ahead. The Central Bank's next comprehensive analysis of economic developments and prospects will appear in *Monetary Bulletin* in mid-May.

Honoured guests: As has been reported, the Central Bank bought large amounts of foreign currency in 2015 and has continued to do so this year. From May 2013, when the Bank began its regular FX purchase programme, until the close of business yesterday, the Bank was a net buyer of foreign currency in the amount of 471 b.kr. Some of this currency has been used to pay down foreign debt and the rest to increase the size of the foreign exchange reserves. Both of these measures increase the proportion of the reserves financed in krónur. At the end of February, the reserves totalled 721 b.kr. including 382 b.kr. financed in krónur. This has reduced foreign liquidity risk, of course, but it would also have a large negative impact on the Bank's finances if such an arrangement persisted, as domestic interest rates are much higher than the rate of return on the reserves. This point is discussed in greater detail in the Bank's Annual Report, which is available here today. The report states that, as of year-end 2015, the negative interest rate differential on the Bank's foreign exchange balance was 18 b.kr. on an annualised basis.

The forthcoming auction of offshore krónur could change this position radically, however, and as a result, there is no reason to despair about the Central Bank's finances. Furthermore, it is at the core of central banking to prioritise macroeconomic objectives over the central bank's own finances. Moreover, this situation could make it possible to resolve most of the problem in the auction, in a more permanent way than was previously envisioned. Preparations for the auction are now well underway, and the date and format will be publicised soon, so that the auction can take place in the first half of the year. Other things being equal, it should then be possible to move relatively quickly towards lifting capital controls on residents, as the current account surplus, foreign exchange inflows, and robust foreign exchange reserves provide ideal conditions for it. On the other hand, it is important to reach successful conclusion regarding offshore krónur before general liberalisation of controls on residents can take place.

Now I would like to turn to longer-term issues regarding monetary policy and its relationship to other aspects of economic policy and prudential policy. In its reports entitled *Monetary policy after capital controls* and *Prudential rules following capital controls*, published in 2010 and 2012, respectively, the Central Bank described the new monetary policy framework and prudential rules that will be necessary to preserve financial stability and support monetary policy after the capital controls are lifted. The assumption underlying both reports was that the Central Bank's key objective would continue to be price stability, as is mandated by law, and that the exchange rate of the króna would remain flexible, although it would not need to be entirely free-floating. I will not explain the grounds for these assumptions here, as they have been discussed widely, except to point out that it is unrealistic to entrust monetary policy with objectives other than those it has the chance to fulfil using the available instruments, and that adopting a fixed exchange rate would eliminate the advantages of an independent currency and independent monetary policy without eliminating the disadvantages. Therefore, policy formation lies in finding a framework that can work under the above-described conditions.

There were a number of drawbacks to Iceland's pre-crisis monetary policy framework. A major flaw was the lack of an adequate response to the excessive capital inflows that contributed to credit and asset price bubbles and domestic residents' significant foreign exchange risk, which was to a large extent unhedged. Furthermore, monetary and fiscal policy were not well enough aligned, and the same can be said of other Government decisions that affected demand. The burden on monetary policy was therefore greater than it would have been otherwise, which further stimulated capital inflows. This, together with strong demand, pushed the real exchange rate higher than it would have been otherwise and exacerbated macroeconomic imbalances, as could be seen most clearly in a sizeable current account deficit. These developments and the banking crisis contributed to the currency crisis that struck in the first half of 2008.

The Bank's two publications on post-capital controls monetary policy and prudential rules have stood the test of time, as many of the proposals in them have already been implemented. We now intervene in the foreign exchange market with the aim of smoothing out fluctuations due to temporary capital flows and mitigating short-term exchange rate volatility. We no longer have a free-floating currency, but a managed float. We have adopted prudential rules that severely limit the banking system's ability to take risk in foreign currencies. We have established a Financial Stability Council and a Systemic Risk Committee in order to monitor financial system risk more effectively than we did previously, and we are developing prudential rules and macroprudential tools to respond to systemic risk. This will also support monetary policy.

One important step remains, however: to develop policy instruments that can be applied so as to curtail carry trade-related capital inflows when such inflows interfere significantly with the transmission of monetary policy along the interest rate channel, as was the case last summer and autumn. Analysis of the options available has been underway in the recent term, but these mainly involve a tax or a special reserve requirement. In both instances, statutory amendments would be necessary. It can be argued that such policy instruments should be on the law books by the time the auction of offshore krónur takes place because, if the auction is as successful as we intend, it is possible that confidence in Iceland will grow still further and capital inflows will increase.

Why do we need all of these additional tools and contingency measures? An important reason is the risk to financial stability that accompanies excessive and volatile capital movements that are unconnected to economic fundamentals. Another important reason is that in an increasingly financially integrated world, it is more difficult for small countries to deviate too far from the monetary policy pursued in the larger countries that determine global financial conditions. We saw this before the financial crisis, in New Zealand and here in Iceland. And we have seen it more recently, in countries like Switzerland and Sweden.

We can better understand why this is so if we consider a situation where cross-border financial integration is nearly perfect, so that capital movements very quickly even out the difference in risk-adjusted real returns on assets in different countries. The interest rate channel of monetary policy transmission then becomes clogged up in small, open, and financially integrated economies, where long-term interest rates are determined by rates in large countries and transmission takes place largely through the exchange rate channel. But transmission through the exchange rate channel is uncertain and volatile, as the exchange rate is also an asset price that fluctuates with speculative capital flows and can deviate from equilibrium over time, only to correct quite suddenly. Unless the financial system is that much better protected, this process can interact negatively with financial stability, as was the case in Iceland during the financial crisis. This is at the heart of the problem faced by small countries that pursue independent monetary policy and permit unrestricted capital flows simultaneously. The problem can be solved by adapting monetary policy to that prevailing in large countries even though it is not suited to domestic conditions, or by placing restrictions on cross-border capital flows, particularly those related to carry trade. The need for such restrictions is likely to surface earlier and more strongly in countries with shallow financial markets.

But capital flow management measures that aim to restrict both carry trade and destabilising capital movements cannot be used as the first line of defence in the fight against inflation and macroeconomic imbalances, except under extraordinary circumstances. Such instruments will have adverse side effects and could push international obligations to their limits. But some sort of tools must be available for use if the need arises. In general, the first line of defence must be conventional management of the monetary-fiscal policy mix, supported by structural reforms and sound economic incentives. The second line of defence, then, is prudential rules and macroprudential tools aimed at hindering excessive indebtedness, enhancing financial system resilience, and mitigating procyclicality. Capital flow management tools are the third line of defence and are intended to support other aspects of economic policy if the need arises.

In formulating a new economic and prudential policy framework in the near future, we must try to make the interactions between the various components most conducive to achieving the desired results. This applies to fiscal policy, monetary policy, decisions made in the labour market, and decisions designed to safeguard financial stability. In this context, it should be borne in mind that monetary policy is unique in that it can have a very rapid response time, as its instruments can be applied at short notice. This means that monetary policy can have the last move and can consider the decisions made in other policy areas. Furthermore, experience shows that monetary policy is most effective in the long run if central banks are independent in applying monetary policy instruments but have clear objectives decided by elected representatives and are then accountable for their decisions after the fact. The framework for the interactions among the various components of economic policy must not limit this independence. This does not change the fact that, for these interactions to have maximum effectiveness, there must be a clear understanding of which factors will determine the decisions of each party. And the greater the consensus on the analysis of the situation and outlook, the more effective it will all be. One way to promote this is to establish a forum for discussion and exchange of information without restricting each party's legally defined role. In this context, I welcome the forthcoming establishment of a Macroeconomic Council with representation from the Government, the labour market, and the Central Bank. It has also been decided that the Monetary Policy Committee and the Systemic Risk Committee, which prepares analysis and recommendations for the Financial Stability Council, will hold a joint meeting at least once a year. The first such meeting took place last November.

Honoured guests: The financial system plays an important role in the functioning of modern society, in channelling diversified saving towards a profitable but larger investment, assessing and diversifying risk, and intermediating payments between parties in the economy. It would be difficult to engage in modern external trade if we did not have some sort of domestic banking system that worked with foreign banks and could transmit payments across borders. The financial system is therefore an inalienable part of value creation in a modern society. Its importance is often forgotten in the heat of negative discourse but is never as clear as when things go wrong – as they did in the financial crisis.

The structure and condition of the financial system at any given time is determined by historical factors, economic and market conditions, the regulatory environment, technology, and culture and ethics. The Central Bank and the regulatory environment are also part of the financial system. The public sector can affect developments in the financial system through the regulatory framework, through transactions with the system – not least through the Central Bank – and by affecting culture and ethics.

At present, the system is shaped by the financial crisis and the responses to it, including the capital controls. It is a relatively homogeneous system dominated by three domestic-oriented banks with similar business models and risk profiles. The capital controls, implementation of international regulations, and more stringent Icelandic regulations on foreign exchange risk all affect the banks. The capital controls will be lifted, but much of the regulatory environment will remain.

Risk in the financial system has diminished markedly in recent years as resilience has grown, which can be seen in capital adequacy and funding; furthermore, liquidity relative to the scope of operations is much greater than before the crisis. The three largest commercial banks' combined capital amounted to 669 b.kr. at the end of 2015. The banks' equity ratios have risen by nearly a third since 2010, from 21% to 28%. In real terms, their equity has increased by 180 b.kr. over this period.

Furthermore, the banks' foreign exchange imbalances have been reduced, and the regulatory framework prevents excessive risk-taking in foreign currencies. Moreover, risk related to borrowers has diminished as the economic recovery has progressed and debt levels have fallen; indeed, at the end of 2015, total private sector debt was down to around the level last seen in 2000.

Financial system risk is assessed four times a year by the Systemic Risk Committee and the Financial Stability Council, greatly increasing the monitoring that takes place. The Central Bank publishes its *Financial Stability* report twice a year, with the next issue forthcoming on 20 April. I will not expand further on this here.

However, I think it appropriate to mention four issues that, in the near future, could have a major impact on long-term developments in the financial system.

The first is technology, which is advancing rapidly worldwide. In addition, we are engaged in renewing many of Iceland's key financial market infrastructure elements and, in doing so, adopting new technology. This could create excellent opportunities to enhance security and reduce costs, including through joint utilisation of infrastructure elements, while increasing competition in areas where economies of scale are less in evidence. The Bank's *Financial Market Infrastructure* report, to be published later this year, will discuss this in greater detail.

The next is culture and ethics. In international discussion, it is widely emphasised that post-crisis reform will not achieve its goals in the long run unless it involves an improvement over the pre-crisis situation. It seems to me that considerable improvements have already been made here in Iceland. But there is more to be done, and it is a long-term project. It is also necessary to drive home the point that bank directors' role is not only to maximise short-term profits; as the system is currently structured, bank directors are also guardians of public goods as represented by joint financial market infrastructure.

The third is financial literacy. A number of studies show that increased financial literacy enhances financial market stability, monetary policy transmission, and understanding of monetary policy actions. This is why the Central Bank has participated in and supported the preparation and implementation of Financial Literacy Week in recent years and intends to continue doing so. It so happens that Financial Literacy Week is underway right now.

The fourth topic is discussion of what type of financial system we need and want as we emerge from the aftermath of the financial crisis. That includes the international aspect of the system, the scope of the system, and whether we need to shelter our infrastructure even more from risk-taking than we have already done with recent and planned reforms, including forthcoming legislation on insolvency and winding-up of financial institutions. In this context, there are other options available than the complete separation of commercial banking from investment banking. After important steps concerning capital account liberalisation are complete, which will be soon, there will be opportunities to say more about these topics and others.

And now I have come to the conclusion of my speech today. We are not yet finished settling the financial crisis, but that moment is rapidly approaching. I would like to thank the Supervisory Board and the Monetary Policy Committee for its work over the past year, and I wish to thank the Central Bank's many colleagues and collaborators for their cooperation – not least the Prime Minister's Office, the Ministry of Finance and Economic Affairs, and the Financial Supervisory Authority. I would also like to thank the financial institutions with which the Bank interacts for their cooperation. Moreover, I would like to thank the Parliament of Iceland, particularly the Economics and Commerce Committee, for their collaboration. And last but certainly not least, I want to thank the staff of the Central Bank for a job well done over the past year.