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Speech

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Prime Minister, other ministers, Chairman of the Economic Affairs and Trade Committee and other members of Parliament, bank directors, foreign ambassadors, other honoured guests!

This is the last speech I will give at the Annual Meeting of the Central Bank of Iceland, as I will step down as Governor this August, as is provided for by law, after ten years in the position. I would therefore like to focus on matters other than current tasks relating to monetary policy, financial stability, and other Central Bank functions, but it is unavoidable to make an assessment of the most recent events. I will focus on two main areas. First of all, I would like to take a backward glance at developments in the Icelandic economy and financial system over the past ten years. In this context, I will give my assessment of how successfully the Central Bank has achieved its objectives. The published and printed versions of this speech will include selected charts that illustrate economic developments over the period. Second, I will take a look at the future and discuss several challenges in connection with the Central Bank's tasks and objectives.

Let us now cast our minds back to mid-2009. At that time, Iceland was in the midst of its severest economic contraction since World War I, a century ago. GDP contracted by nearly 13% from its Q1/2008 peak to its Q1/2010 trough. This caused unemployment to soar — although with a lag, as always — to a post-war high of over 8% in Q4/2010. Inflation had peaked at nearly 19% in January 2009 and had fallen back to about 12% by mid-year. At the same time, the Central Bank's key policy rate had been lowered from 18% to 9½%. State and local governments were hit hard by the economic contraction and spike in unemployment. In 2009, the public sector deficit was nearly 10% of GDP, excluding one-off items such as the recapitalisaton of the Central Bank. Gross public sector debt peaked in 2011 at 92% of GDP. Iceland's net external debt position was poor as well, with external debt exceeding external assets by nearly 130% of GDP at the end of 2008, excluding the estates of the failed banks. During the run-up to the financial crisis, Iceland's international reserves equalled only 12% of GDP. They grew somewhat with the first drawdown of the loan in connection with the economic programme with the IMF, to about 24% of GDP by mid-2009. Nearly all of Iceland's reserves were financed with foreign credit.

So the situation was difficult, but in addition, there was substantial uncertainty about what would happen next. Would we succeed in stopping the depreciation of the króna, which was still ongoing, partly because the capital controls weren't working as intended? The second review of the economic programme with the IMF, and the disbursement of the second tranche of the loan facility, was delayed because of the Icesave dispute. The capital controls had sequestered an overhang of offshore krónur amounting to some 40% of GDP, and it was not yet known how big a balance of payments problem lurked in the failed banks' estates, as the split between the new and old banks had not been completed. The new banks had not yet been capitalised sufficiently, and non-performing loans represented a major problem. As a result, it was highly uncertain how the new banks would fare. Would efforts to put public sector finances on a sustainable footing be successful? In short, all three of the key objectives of the IMF programme were still up in the air: exchange rate stability, fiscal sustainability, and financial system reconstruction.

We know now that the turnaround was just around the corner. The economic contraction, of course, was a consequence of the financial crisis, but it also stemmed from the inevitable adjustment of unsustainable economic imbalances and from the contraction of bloated sectors such as construction and financial services. The adjustment showed most clearly in the current account balance, which flipped from a double-digit deficit before the crisis to a sizeable surplus as early as 2009. Such a swift and sizeable turnaround is a rarity in international context and has drawn considerable attention. The drop in the real exchange rate by 45% from the pre-crisis peak played a role in this adjustment, although it overshot, initially causing severe side effects because of the large stock of foreign-denominated debt owed by resident borrowers without any natural hedging in the form of foreign income or assets. As a result, strong emphasis was placed on halting the collapse of the króna. This was achieved in H2/2009. Closing loopholes for capital outflows and adopting measures that allowed the capital controls to work as intended made a big difference in this regard.

The economic recovery began once the exchange rate had been stabilised and the inevitable adjustment of domestic demand to a new economic reality was more or less complete. The economy gained resilience through the underlying strength of the sectors that had not been part of the bubble economy — conventional export sectors in particular. Firms in the tradable sector took advantage of the low real exchange rate.

The economic upswing began in Q2/2010, when GDP began to grow once again. GDP has grown more or less without interruption since, and in terms of GDP per capita this is Iceland's longest economic upswing since the end of World War

II. Early on, growth was weak in comparison with previous upswings, as it was driven mainly by closing the slack in the economy, as investment was relatively weak at the outset. That changed in 2015, when tourism began to grow at an unprecedented pace, terms of trade improved, and investment picked up. That year the output slack closed and a positive output gap opened up, and sustained growth without economic overheating called for increased labour importation.

In recent years, Icelanders income has risen above its pre-crisis peak, owing both to GDP growth and to the improvement in terms of trade. Real wages were 24% higher in 2018 than in 2007, and real per capita income was 12% higher. According to international statistics, Iceland ranked 11th in the OECD in terms of per capita income in 2007. We dropped to 19th place in 2010, but by 2017 we were up to sixth place.

I always expected that the economy would recover, but I dared not dream that we would get to where we are today. As I mentioned in my speech at the 2010 Annual Meeting, I was also worried that the endemic imbalances in the Icelandic economy would surface again once the economic recovery was further advanced. This could manifest itself in economic instability, an unsustainable external position, and above-target inflation. Fortunately, that did not happen. We have experienced a long, sustained period of growth. Certainly, a positive output gap could have ended in overheating and instability. But we managed to avoid this with imported labour and prudent economic policies, particularly monetary policy. Now the output gap is narrowing quickly, but without yet giving way to an economic contraction.

In the future, considerable effort will probably be spent on seeking explanations for this success. At the top of my list of explanations is the nature of the shocks that struck in autumn 2008. The damage caused by the failure of the Icelandic banks affected many more countries than Iceland alone. The economic adjustment was unavoidable, as I mentioned, and the contraction was most pronounced in bloated sectors, while a large share of other business activities retained their strength, conventional export sectors in particular. Second on my list is the way in which the measures taken when the banks collapsed contained the damage and kept the cost of the failed private banks from landing too heavily on the general public. Third is the economic programme of the Icelandic authorities with the IMF, and the economic policy pursued thereafter. All three of the key objectives of the IMF programme were achieved. Fourth is our success in lifting the capital controls without balance of payments disequilibrium and while preserving financial stability. Fifth is the integration of the domestic economy with trading partner countries, particularly through the EEA Agreement. This made it easier to cushion the blow by exporting labour and other production factors and then importing when demand pressures were about to become too strong. Sixth is just good luck, pure and simple, which is one of the factors underlying the tourism boom and the improvement in terms of trade in recent years.

On the whole, things have gone well, although naturally, it was not all successes. We must not forget, either, that financial crises of the magnitude of the one in Iceland cast long shadows, and many have faced hardship for a long time afterwards. This underscores the necessity of safeguarding financial stability.

The Central Bank's contribution to this successful outcome is threefold: formulation and implementation of monetary policy; participation in the resurrection of the financial system and the formulation and implementation of financial stability policy; and participation in the development of the capital account liberalisation strategy and the execution of the strategy. I will now turn to these three factors and, as I do so, move to the present day.

Inflation subsided in 2009 and 2010 as the inflationary impact of the steep drop in the exchange rate in 2008 tapered off and the exchange rate stabilised in H2/2009 and then began to rise in 2010. Inflation declined steadily until it fell to target in late 2010. As inflation eased, Central Bank interest rates were cut, reaching a low of 3½% early in 2011. Inflation expectations remained above the target, however. In H2/2011 and 2012, inflation rose again following the depreciation of the króna and large contractual wage increases. We know now that monetary policy achieved good results in its response to this situation. The response consisted of interest rate hikes and signalling of further ones to come, but also of more active use of other policy instruments such as foreign exchange market intervention and, later, the special reserve requirement on capital inflows into the bond market and high-yielding deposits. Monetary policy was successful in bringing inflation — and thereafter, inflation expectations — back to the target after 2012, without sacrifice costs in terms of employment Furthermore, the use of new policy instruments helped ensure that the exchange rate of the króna was countercyclical rather than procyclical, as it had been to some degree before the crisis. Inflation remained close to the target for about five years.

When the banks failed in autumn 2008, new banks were established virtually overnight. These banks received deposits in Iceland and matching assets, and became a new channel for domestic payment intermediation. There was hardly a hiccup in domestic payment intermediation, which has to be considered quite a feat. As I mentioned earlier, the task of recapitalising the banks and finalising the new-bank-old-bank split remained. It was decided that the old banks should take an equity stake in two of the new ones. To begin with, there were sizeable imbalances in the banks' balance sheets, including foreign exchange imbalances, and non-performing loan ratios were very high. As a result of various measures and the economic recovery, the imbalances subsided and non-performing loan ratios fell rapidly from 2011 onwards. Since 2015, they have been relatively low in historical context. The banks' capital adequacy ratios increased, both for these same reasons and because the Financial Supervisory Authority prohibited dividend payments without explicit approval during the banks' first years of operation and the capital controls made dividend payments to foreign creditors less feasible. At the same time, the regulatory framework for the banks' operations was improved significantly.

Now we have a banking system that primarily serves domestic households and businesses and, in terms of total assets relative to GDP, is about 15% of its pre-crisis size. As can be seen in their high capital adequacy ratios and sound liquidity position, the banks are quite resilient.

Their capital ratios have fallen in recent years as a result of dividend payments, and it can be said that there was scope for such a reduction. But now their capital ratios are much closer to the Financial Supervisory Authority's capital requirements, and under current conditions of elevated economic uncertainty, it would be imprudent to lower them much more with dividend payments. In this context, it is important to bear in mind that the current capital requirements also include buffers that can be used without the banks being deemed to have failed. These capital buffers are a sort of cushion, and if they are tapped, resilience-enhancing measures such as restrictions on payments of dividends and bonuses will be adopted. Furthermore, the countercyclical capital buffer can be lowered very quickly if conditions warrant it, although it has been decided to increase it to 2% in the coming term.

On the whole, the 2008 IMF programme objective of rebuilding the banking system on firmer foundations was met successfully. Certainly there are a number of questions and challenges regarding future developments in the banking system and the regulatory framework for it, as has emerged in the recent *White Paper on a Future Vision for the Financial System,* but further discussion of that topic must await another opportunity.

Early this month, Parliament passed legislation lifting restrictions on the remaining stock of offshore krónur, which amounted by that time to 84 b.kr., or just under 3% of GDP. This represented the final step in lifting capital controls on non-residents' króna-denominated assets. The assets fell into two categories: so-called offshore krónur, on the one hand, and króna-denominated assets held by the failed banks' estates, on the other. These assets combined amounted to 65% of GDP at the peak. We reduced that percentage to the current level through various measures taken in 2010-2017 — without disturbing the balance of payments or financial stability, without tapping the Bank's reserves to an inordinate degree, and without significant legal repercussions. This success has been noticed, including internationally.

Alongside the final liberalisation of offshore krónur, the special reserve requirement on capital inflows into the bond market and high-yielding deposits was lowered to 0%. This synchronised effort has delivered positive results. The exchange rate of the króna has not been under pressure due to offshore króna outflows, and the Central Bank has not yet needed to use significant reserve assets in order to fulfil its pledge not to allow those outflows to weaken the currency.

Honoured guests: The news that WOW Air has discontinued operations broke this morning. With that, a part of the risk facing the Icelandic economy in the recent past has materialised. Last autumn, the Central Bank conducted a scenario analysis providing for the potential collapse of WOW. It was clear that the impact on the economy would depend to a substantial degree on how quickly, and to what extent, other airlines would step into the breach. The analysis was based on WOW Air's size and operations in 2017. The WOW Air that closed shop this morning is about half that size, according to a very rough estimate. Nevertheless, it is clear that WOW's collapse will have a negative impact on GDP growth, particularly in 2019. It is unlikely that this alone will push Iceland into a contraction this year, though. On the other hand, this shock comes on the heels of others, such as the failed capelin season. In addition there are risks that have not yet materialised, including the possibility that wage settlements will be out of line with price stability and the repercussions of a disorderly Brexit. If these risks do materialise, a temporary contraction cannot be ruled out.

In this context, it matters greatly that we are now more resilient and better able to mitigate shocks than perhaps at any time in our history. I have already mentioned many of these strengths here today. They centre on the ability of the economy and financial system to face shocks because of a good external position, large international reserves, and households' and businesses' relatively strong equity position. The banks are strong as well, as I have just explained. Furthermore, economic policy has considerable scope to respond, and more than in many other countries. The Treasury is running a surplus, and public debt is historically low. There is significant scope to lower interest rates if conditions call for it, unlike in many of our trading partner countries, as Iceland's interest rates are well above zero.

Honoured guests: In my speech today, I have focused on our experience of the past decade and our current position. Now I would like to address some of the challenges ahead for the Central Bank.

The first pertains to how we can preserve stability under conditions of virtually unrestricted movement of capital. The Central Bank of Iceland has been preparing itself for this for years. In 2010 and 2012, the Bank published two reports on monetary policy and on prudential rules post-capital controls. Much of what is proposed there has already been put in place. I have discussed these topics extensively, verbally and in writing, in Iceland and abroad. Some of that material can be found on the Bank's website.

The big picture has been sketched out. Unrestricted movement of capital is of great benefit for a small open economy, but there are also significant risks attached to it. Such risks, and the fact that they were not addressed, played a major role in the run-up to Iceland's financial crisis. We have tried to learn from this. In addition, it is clear that small open economies that are financially integrated with the rest of the world face increasing difficulties in pursuing independent monetary policy without jeopardising financial stability if they adhere to conventional economic and prudential policies. To solve this problem, it is not sufficient to have a floating exchange rate. Additional tools and measures must be applied. Among them are foreign exchange market intervention, conventional macroprudential tools, and rules that limit foreign exchange mismatches in domestic balance sheets. Conditions could arise, however, where this would not suffice, and then it could prove necessary to activate capital flow management measures like the special reserve requirement that we have used in the recent past. This mainly occurs when the exchange rate is higher than is warranted by economic conditions, international reserves are ample, and the economy is on the verge of overheating. Under such conditions, it is difficult to use exchange rate flexibility, foreign exchange market intervention, or interest rates to counteract capital inflows.

The next challenge is to ensure secure, efficient, and economical payment intermediation. Last year the Central Bank issued a report on retail payment intermediation from the standpoint of contingency and financial stability. It discusses important public interests. Unfortunately, the Bank has not been able to follow up sufficiently with presentations and discussions, but the aim is to do that in the near future, including with the establishment of a so-called Payment Council, a forum for dissemination of information and exchange of opinions among key stakeholders. The Council's first meeting is planned for next month.

In many respects, electronic retail payment intermediation has been effective and secure in Iceland, in part because it has been based largely on Icelandic core infrastructure and real-time settlement. Internationally, real-time settlement is a widespread goal, and it is therefore important that we do not backtrack on that point.

One of the factors that was of vital importance for domestic retail payment intermediation during the financial crisis in autumn 2008 was that the Icelandic authorities could take control of domestic payment intermediation and guarantee continued functioning without external involvement. In view of the changes currently taking place in domestic retail payment intermediation, it is no longer a given that the authorities will be able to respond in the same way. It is therefore appropriate to ponder how best to ensure continued functioning of electronic payment intermediation if an unexpected incident or shock should occur. To an increasing degree, domestic electronic payment intermediation is viewed as an element in national security — that the authorities must guarantee, directly or indirectly, that there will always be a domestic payment channel independent of foreign entities. The existence of alternate routes that can be used if the main systems malfunction enhances the security of retail payment intermediation. Physical cash in the form of banknotes and coin plays the same role. But it is consistent with the requirements of our time that there must also be electronic payment routes that are independent of foreign card systems' core infrastructure. Elsewhere in the Nordic countries, such independent electronic solutions have been in place for some time. A comparable technological solution is now ready in Iceland — a payment solution based on domestic financial institutions' core infrastructure — but it has not yet been put into general use. This is not acceptable, given the possibility that this solution will improve security and enhance efficacy and efficiency for the benefit of Icelandic society.

Bills of legislation providing for the merger of the Central Bank and the Financial Supervisory Authority have been introduced before Parliament. This is a large and complex project that I do not have time to discuss at length here. In important ways, the changes provided for in the bills are major improvements. Chief among them is the fact that they make monitoring financial stability more effective and efficient, and they allow for better harmonised formulation of monetary, financial stability, and financial supervision policies. In addition, it is ensured that the Central Bank, as lender of last resort, will have a good enough overview to take the best decisions possible when the need is greatest. The experience of the financial crisis has taught us that this is important.

In closing, I would like to thank the Supervisory Board and the Monetary Policy Committee for their collaboration, 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. Furthermore, 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 their tirelessness, dedication, and outstanding work in the past ten years. And at this turning point, I would like to extend my sincerest thanks to all of you who have come here today and have attended the Bank's annual meetings in the past. Central banks can be a force for change, but history and tradition are also strong, and they contribute to strength and steadfastness in the work they do at any given time. It means a great deal to me that here today are two former Governors and other former Central Bank employees have attended the Annual Meeting every year during my term as Governor. Thank you for that.