

Minister of Finance and Economic Affairs: address at the 53rd Annual General Meeting of the Central Bank of Iceland, 27 March 2014

It is particularly satisfying to me to have this opportunity to discuss the Icelandic economy in a larger context this afternoon. Through its monetary policy function, the Central Bank plays a major role in this broader context, and it makes an important contribution towards building up and maintaining the stability that is so important to us.

Through the decades, volatility has been the Achilles heel of the Icelandic economy. If one species of fish changes its behaviour patterns and swims into or out of Iceland's fishing waters, or yields to Nature's unending quest for equilibrium, the domestic business cycle follows suit. It should be our goal to take intelligent advantage of the upswings and try to spread their effects out, so as to use them to mitigate the inevitable downward cycle.

We are still wrestling with the repercussions of the recent economic collapse, but it is nonetheless appropriate that we prepare ourselves to work towards mitigating economic expansion so as to ensure lasting stability.

This is a welcome task, as it is based on last year's GDP growth of 3.3% and the Central Bank's projection of 3.1% average growth over the next three years. The labour market is recovering. According to the most recent figures, unemployment was down to about 4% in February.

Private sector wage agreements bear witness to a broad-based desire to preserve purchasing power through contracts that safeguard real wage increases, not through large nominal pay increases that are little more than impressive numbers quickly burned up by inflation. This prudent position taken by the labour market has already borne fruit, as can be seen in inflation forecasts and in consumer sentiment indices, which have risen sharply in the recent past.

Spring is coming for the Icelandic economy.

That said, we should remember that Icelandic spring can be volatile in the extreme. The capital controls imposed some five years ago cast a shadow on us. They are unusual in an economy like ours, which bases its activities on free trade and unrestricted transactions with the world's major markets.

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Lifting the controls is a key element in restoring Iceland's competitiveness and free trade environment. It is not only the creditors of the failed banks that are locked in by the capital controls, although discussion often focuses on them. The capital controls are a burden on the entire domestic economy: firms, pension funds, and individuals. They restrict our options for risk diversification, and as long as they remain in effect, we cannot participate in international trade on normal premises and therefore miss out on opportunities for growth.

Various steps have been taken in order to gradually create the conditions required to lift the controls. Public sector finances have been brought under control, and a huge fiscal deficit has been turned into a surplus. Restrictions on capital inflows have been lifted, and a special investment programme has been created to attract foreign capital. The pension funds have brought substantial foreign capital into the country, the Central Bank has used its foreign reserves in individual transactions so as to relieve pressure, and the Treasury has issued foreign bonds, thereby paving the way for other domestic borrowers to obtain foreign financing.

For the past five years, Iceland's real exchange rate has been very low in historical context, and investment has been at an all-time low, which has delivered a trade surplus amounting to about a fourth of GDP over this period. Needless to say, this is quite an abrupt turnaround in a country with a decades-long history of an external trade deficit.

But in spite of all of these changes, Icelandic households and businesses are still shackled by the capital controls, and the real exchange rate of the króna is still low, with the associated effect on our living conditions. News reports earlier this year suggested that these shackles were caused by Iceland's being frozen out of foreign

capital markets because of the authorities' disputes with foreign creditors – reports that proved to have no basis in fact.

The risk premium on the Treasury's US dollar bonds has declined somewhat in the recent term, which is very good news. International credit rating agencies deem the outlook stable, and the thermometers in the global financial markets emphatically do *not* indicate that Iceland has been frozen out. Quite the contrary: the sovereign is well able to access foreign credit at this point in time.

The Government has assigned top priority to capital account liberalisation, an important element of which is the settlement of the failed banks' estates. The Icelandic authorities are not in any direct negotiations with the old banks' creditors, as the creditors' claims are not against the State but against domestic financial institutions that are being wound up. It is the task of the winding-up committees and the creditors to seek composition agreements settling the claims between them, and neither the Central Bank nor the Government is directly involved in preparing the agreements themselves. The authorities' role is to ensure that capital controls exemptions requested by the estates for disbursements to creditors do not have a negative effect on the domestic economy and those participating in it.

The problems relating to the estates and their potential negative impact on Iceland's economic stability are the main hindrance to our progress in lifting the controls. It is of vital importance for Iceland that this matter should be resolved successfully. I reiterate what I have said before: I remain optimistic that this year we will be able to take major steps towards facilitating liberalisation of the controls, and I think there are various signs indicating that expectations concerning payouts of ISK assets in foreign currency have grown more moderate.

Nonetheless, it should be borne in mind that the banks' estates cannot be expected to remain in perpetual operation. In the US, for example – there is a winding-up deadline of three years, which can be lengthened to a total of five years under extraordinary circumstances. Iceland's failed banks have now been in winding-up proceedings for over five years. If creditors cannot manage to conclude composition agreements, the only thing left to do is to place the estates in bankruptcy proceedings.

Another point that should be made is that the current ownership structure of the Icelandic banks cannot be allowed to persist for the long term, capital controls or no.

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The Government that took office just under a year ago set a goal of working swiftly to gain control of fiscal affairs. The first months were dedicated to identifying weaknesses in planning and operations, which were numerous when we took office. Debt levels are too high, and we placed strong emphasis on arresting the automatic accumulation of fiscal debt. We have done this by presenting a balanced budget for 2014 – the first balanced budget in six years.

Reducing public debt can be called one of the cornerstones of economic policy. And indeed, I shudder to think what Iceland's position would have been in the autumn of 2008 if the Government had not been all but debt-free.

A small economy like ours, which is vulnerable to external fluctuations, must set ambitious goals for low debt levels and must take the long view as regards fiscal policy. This is our objective with the new bill of legislation on public sector finances that the Government finalised at its meeting this morning. It incorporates longer planning periods and more tightly structured policy, in addition to stricter fiscal rules.

Among other targets, Government operations must be in surplus over each five-year period, and the deficit may not exceed 2.5% of GDP in any single year. A debt ceiling will be introduced in the amount of 45% of GDP, excluding pension obligations and accounts payable, but including cash and deposit balances. The rules also include guidelines on how the debt targets are to be reached. The passage of this bill will incorporate a much greater level of discipline into fiscal policy.

Also before Parliament is a bill of legislation on a financial stability council. The council is to supplant the financial stability committee, which is the current forum for consultation, exchange of information, preparation of recommendations for financial

stability, and coordination of contingency measures in response to potential financial shocks.

The bill of legislation addresses one of the main weaknesses that surfaced after the financial crisis: the lack of a link between macroprudential and microprudential supervision of the financial markets, which meant that no single official body had a comprehensive overview of the state of the financial system.

Included in the bill is a recommendation that a Government forum be established to oversee the status and evolution of the financial market and that a formal statutory framework be created for it.

The bill recommends the establishment of a financial stability council and a systemic risk committee, whose task will be to carry out preparatory analysis for the council.

Neither the financial stability council nor the systemic risk committee is intended to disturb the independence of the Central Bank of Iceland or the Financial Supervisory Authority, but experience in Iceland and abroad suggests that financial market shocks call for direct or indirect government involvement. It is therefore critical that responses to such shocks be under the leadership of the minister in charge of Government finances.

If these bills of legislation on public sector finances and the financial stability council are passed, they will strengthen our economic policy framework for the long term.

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A work group formed by the Ministry of Finance and Economic Affairs and the Central Bank of Iceland has been working on revisions to the financial interactions between the Treasury and the Bank. Among the issues under examination are the rules on the disposal of the Bank's profit and the assessment of its equity. In its work, the group examined expert reports, consulted with outside specialists, and studied comparable legislation in neighbouring countries.

The parties agree that the current equity criteria and arrangements for disposal of the Bank's profit do not provide adequately for the Bank's financial independence and that, in some instances, could work against monetary policy objectives. For instance, a situation could arise where the Bank was required to pay a transfer to the Treasury even though its equity was inadequate. Similarly, under the current framework, equity could end up being much stronger than necessary.

The analysis of the Bank's financing structure and capital position shows that it is possible to maintain capital strength while reducing paid-in equity. It is planned to use those funds to reduce the bond issued by the Government to recapitalise the Bank in the wake of the collateral losses it suffered when the banks failed. In addition, the terms of the bond have been renegotiated on the basis of an agreement made at the turn of the year. The bond will bear nominal interest based on the Bank's current account rate and will be payable in fixed instalments over a period of 29 years.

In drafting the new rules on equity and transfers to the Treasury, the main considerations were to enhance the Bank's financial independence, use the capital the Treasury has at its disposal, and place the financial interactions between the Treasury and the Bank on a more permanent footing. These goals will be reached by managing the Bank's balance sheet so as to ensure both that income from interest-bearing assets covers operating expenses after accounting for non-interest-bearing liabilities, and that equity reflects the risk facing the Bank at any given time.

The new equity and transfer rules enhance the credibility of monetary policy, as they strengthen the market's confidence in the Bank's financial independence and its scope to undertake necessary monetary measures. In addition, more effective disposal of capital ultimately reduces Treasury debt, thereby reducing interest expense. Moreover, the financial interactions between the Treasury and the Bank will be more formal, more reliable, and more transparent.

A bill of legislation covering these changes is in the final stages of preparation and is to be presented before Parliament in the next several days.

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We have now gained some experience of the organisational structure implemented with the amendments to the Central Bank Act in February 2009, which primarily entailed changing the senior management structure and establishing the Monetary Policy Committee. In addition, the Bank's role has changed markedly following the collapse of the financial system in 2008, and it now includes tasks that the Bank did not have before the crash. It is therefore time to evaluate these changes and reappraise various other elements of the Bank's activities in the wake of the turbulent times that are now behind us.

To this end, I have decided to appoint a committee to undertake a comprehensive review of the Central Bank Act. The committee will conduct a thorough study of the activities of other central banks and of legislation on monetary and economic policy, with the aim of safeguarding the Central Bank's credibility and independence and enhancing confidence in the Icelandic economy. In view of the recent upheaval in the financial markets, the committee will also determine whether there is reason to make structural changes to the financial market and the Financial Supervisory Authority, so as to strengthen the cooperation between it and the Central Bank and clarify the division of tasks between the two institutions.

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Honoured guests:

I believe Iceland is on the right path. This belief is supported by conventional economic indicators, and while this is welcome news, I want us all to remember what has happened during previous upswings and to prepare ourselves to exercise the utmost prudence in economic policy.

We must discipline ourselves to prepare for the future in large and small ways alike. In this vein, the household debt relief package we announced yesterday includes a measure for those who are not yet homeowners, offering them a tax deduction if they put their third-pillar pension savings towards the purchase of a home. In earlier times, we used mortgage savings accounts and mandatory saving for this purpose, in an attempt to keep people from drowning in debt when they bought a home.

Nowadays we have no mandatory savings mechanism, only an incentive, but I believe this can help to bring about a change in attitude towards house purchases.

We need a similar shift in attitude towards fiscal policy. We must adopt a habit of discipline and oversight, we must make plans that extend over longer periods of time, and we must always demand that public funds be used as efficiently as possible. I think we can all agree that paying sky-high interest does not fall into that category.

Predictability, caution, stability, and discipline are the leitmotifs of this Government's economic policy, and we know we share this point of view with the institutions tasked with preserving financial stability in Iceland. I am optimistic that we will be successful in our attempt to create a society where suitable growth coupled with enhanced stability will form the foundation for gradual improvement in living conditions over the long term.

- Slow and steady wins the race.

I would like to close by thanking the Supervisory Board, the Governor, and the staff of the Central Bank of Iceland for a job well done.