

Minister of Finance and Economic Affairs: address at the Annual General Meeting of the Central Bank of Iceland, 26 March 2015

Honoured guests:

A year ago, in this room and on the same occasion, I said that spring weather was ahead for the Icelandic economy – that we were slowly and steadily regaining our previous strength. Since then, a great deal of progress has been made. The situation has continued to improve, and the outlook is vastly different than it was only a few years ago.

Let's take a quick look at the economy:

Treasury performance been transformed. The improved position has been used to close the budgetary gap and halt public debt accumulation, at a time when debt ratios have been falling rapidly. In other words, we have gained the genuine resilience we need to start rebuilding after a difficult recession.

GDP rose to a new high in 2014. It had last peaked in 2008. GDP growth measured 2% in 2014, and the outlook is for even stronger growth this year and next. If forecasts materialise, the current period will be one of the longest continuous periods of output growth in Iceland's recent economic history. At the same time, GDP growth in the EU – the eurozone in particular – is weak. The most convincing signs of recovery can be seen among the EU countries that have remained outside the monetary union.

Iceland's unemployment rate has fallen sharply and is among the very lowest in Europe. Real wages and real disposable income have grown at virtually unprecedented rates in the recent term. This surge in purchasing power is based not least on the price stability that has been achieved in recent months, with

inflation measuring only 0.8% in February and likely to remain at target for the next few years.

We have a sizeable and lasting current account surplus, following a protracted deficit period.

This is nothing short of a metamorphosis, and it represents a marvellous opportunity. But as always, we must move forward cautiously, and we must take nothing for granted about the future. A large number of major issues await resolution.

Work towards lifting the capital controls is proceeding apace. Never before have so many people been employed full-time on this project, and the work is well advanced. In this area, we have benefited immeasurably from the Central Bank's direct participation in the task force for capital account liberalisation and from the large number of Central Bank experts who have contributed directly and indirectly to the project.

The main thrust of the recent and current work has been to design a strategy that enables us to lift the controls without derailing Iceland's economic stability.

Appraisals have been made of various measures and their impact on economic stability. The solutions ultimately implemented will be based on the results of those appraisals.

While this work has been ongoing, Iceland's economic recovery has been smooth and steady, and the conditions for liberalisation could hardly be better than those we currently enjoy.

At present, the task force is finalising its recommendations for measures, which will soon be presented to the steering committee for capital account

liberalisation and then the Government. I therefore have reason to hope that in the first half of this year, major decisions will be taken that will map out the path ahead. In this issue of fundamental importance for Iceland, 2015 will be a year of action.

Honoured guests:

Not too many days ago, I read on the front page of a newspaper, in boldface, that household debt could skyrocket once the capital controls are lifted. I kept on reading and saw that this statement referred to the possibility that the króna would depreciate upon liberalisation of the controls. After I had read still further, I saw that it was also assumed that the króna could appreciate. And it seemed to be assumed as well that the króna could remain stable.

Provocative headlines on this topic are published on a regular basis, and opinions diverge. But in fact, it is precisely because this task is so complex that so much work has been invested in it. As I have already said, the work done on the liberalisation strategy has centred on addressing and then minimising or eliminating the risk of adverse effects on the economy. There is simply no chance that we will participate in some sort of roulette where this key issue is concerned, with so many vital interests at stake.

Ladies and gentlemen: We often hear the question: After the controls – what then?

Let us first consider the post-liberalisation economic framework.

It is clear that Iceland's monetary policy will be based on the Icelandic króna for the foreseeable future. In spite of its many flaws, the króna has served us well during the reconstruction of our economy. It has been pointed out that free flow of capital will lead to greater exchange rate volatility than we currently see. But

that need not be a particular problem, especially if it is possible to construct a framework that allows the exchange rate to reflect developments in the real economy. If the framework and implementation of economic policy are handled with care, an independent, floating currency is the most desirable solution for Iceland's economy after the controls have been lifted.

In order for this to be the case, fiscal policy must provide better support for monetary policy than it has in the past, and it must support a surplus on external trade insofar as is possible. With a current account surplus, the Central Bank should have greater latitude to intervene in the foreign exchange market, as the Bank itself has mentioned, including in its report to the Minister of Economic Affairs entitled "Monetary Policy in Iceland After Capital Controls."

In order to provide support for a reformed monetary policy framework and prevent the advantages of independent monetary policy from turning into disadvantages, the economic policy framework has been strengthened significantly, as has the operating environment for financial institutions. These reforms will both support monetary policy conduct and dramatically reduce the probability that the banks will once again be the source of economic and financial instability.

It is also appropriate to mention that a bill introducing a new organic budget law currently under discussion in Parliament and will bring about a dramatic change in fiscal policy implementation. With this bill, the economic policy role of public sector finance is strengthened through strategy formulation over a longer term than before, through explicit fiscal rules, and through planning for the entire public sector instead of only the Treasury, as before. In particular, it is stipulated that fiscal policy must contribute to economic stability. These reforms lay the groundwork for improved integration of economic policy and allow

fiscal policy to support monetary policy more effectively. A special fiscal council will evaluate whether fiscal policy and planning are in line with fiscal rules and the fundamental principles of sustainability, prudence, stability, steadfastness, and transparency.

Alongside monetary and fiscal policy is the third pillar of economic policy – financial stability – which has been formalised through the establishment of the Financial Stability Council, through provisions in the Central Bank Act stipulating that the Bank must promote financial stability, and through the proposed adoption of new tools such as capital buffers for financial institutions, maximum loan-to-value ratios, and restrictions on foreign-denominated loans. An improved institutional framework makes it possible to monitor the soundness of individual financial institutions, the interactions between institutions, and the interactions between financial institutions and other parts of the economy.

The activities of the Financial Stability Council have begun well, proving that the Council is an important forum for consultation and exchange of information for the authorities, thereby enhancing the possibility of improved oversight of the risks that can be found in the economy.

The Central Bank has taken an important step by adopting new rules on funding ratios and liquidity, so as to reduce the likelihood that the events of the pre-crisis period repeat themselves. By ensuring minimum net stable funding in foreign currencies, the Bank's rules reduce foreign liquidity risk and the risk stemming from unstable short-term funding used to finance long-term foreign-denominated loans.

In order to reduce the risk that Icelandic banks will seek funding from foreign depositors in a restricted business relationship, the Bank has defined such deposits as volatile, thereby making them a less attractive source of funding for

the banks. Deposit insurance legislation also ensures that payments from the Depositors' and Investors' Guarantee Fund will be made in Icelandic krónur.

One of the main economic policy challenges before the crisis was the surge in unhedged borrowers' demand for foreign loans when the Central Bank raised interest rates, with the associated demand-side pressures. When capital began to flow out of the economy, the situation reversed, exacerbating the depreciation of the króna, just as the inflows had contributed to its appreciation. A bill of legislation that I presented recently before Parliament addresses this problem head-on. It restricts such borrowing by individuals and authorises the Central Bank to set rules restricting foreign borrowing by unhedged parties, subject to prior recommendation from the Financial Stability Council.

I also mention a changed regulatory framework for financial undertakings. Since the financial crisis, the EU has conducted a comprehensive review of its regulatory instruments on financial activities. Amendments have been made so as to strengthen financial institutions' capital position, by increasing equity and improving its quality. The more equity a company holds, the greater the risk borne by its owners for its operations. It is considered desirable that owners bear a greater share of operational risk, particularly to include bearing the expense should the companies concerned fail.

When the State sold its 46% holding in Landsbankinn in 2002, the bank's capital ratio was below 6%. Its equity was 16.3 billion krónur. Very recently, at Landsbankinn's annual general meeting, it was decided to pay dividends on last year's operations in the amount of 23.7 billion krónur. This is close to the entire value of the bank in 2002. How can this be? Well, its equity now is not 16.3 billion krónur but 250 billion. Its capital ratio is not 6% but 23%. It is a radically different bank, operating in line with changed requirements and new ways of thinking.

The Ministry of Finance has invested substantial work in implementing EU regulations and directives on financial firms' capital adequacy, and a bill of legislation amending the Act on Financial Undertakings was presented to Parliament early this year. Among other things, the bill provides for capital buffers that financial undertakings must maintain in order to compensate for their systemic importance or the systemic risk related to lending, or as a countercyclical measure. This bill, one of the most important modifications in the policy instruments made available to the authorities following the autumn 2008 financial crisis, is intended to enhance financial stability.

The question was: After the controls – what then? Considering all of the points I have made, I consider it clear that the framework for monetary and fiscal policy will be much stronger after liberalisation than it was before the banks failed, and that in the long run, economic policy will be both more efficient and more successful in responding to systemic risk and/or economic volatility.

We must also bear in mind what I said a few moments ago, that the economy is in balance at present and that conditions are in many ways ideal for liberalisation.

In the next few days, a fiscal plan for the next four years (2016-2019) will be presented to Parliament for the first time. The plan outlines the framework for the next fiscal budget proposal, from which deviations are permitted only if major changes occur in the premises on which the plan is based. The fiscal policy plan represents a watershed in fiscal discipline and steadfastness, and it will facilitate earlier identification of weaknesses and risks in central government operations if premises change substantially.

The plan states clearly that the Treasury's position and that of the general economy is set to improve markedly in coming years. One of the most important risks facing us is the unrest in the labour market.

Unless we take care, the tension that has developed in recent weeks and months, with overbidding and demands for enormous pay increases in one fell swoop, could undermine the progress that has been made in simultaneously delivering robust output growth, price stability, and a current account surplus.

In recent years, the social partners have tried to bring greater discipline to the collective bargaining process and to base negotiations on a realistic assessment of economic conditions. I support these efforts and have held fast to the hope that genuine progress can be made in this area, but I cannot fail to conclude that we are moving further away from the Nordic model we have previously used as a guidepost. If so, it would be a great disappointment.

There is still time to pull together and to ensure a solution that provides important improvements in workers' conditions while maintaining the economic stability we now enjoy.

Honoured guests:

About a year ago, I appointed a committee tasked with conducting a comprehensive review of the Act on the Central Bank of Iceland. The committee was entrusted with conducting 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.

This March, the committee submitted an interim report on the objectives and administrative structure of the Central Bank. The committee's objective is to strike a balance among three disparate objectives: **i)** to ensure the Central Bank's independence; **ii)** to reduce the likelihood that Bank officials will abuse that independence; and **iii)** to encourage thorough, professional work habits and efficient operations.

In my opinion, the committee did its work well and has managed to combine these objectives satisfactorily in its conclusions.

Nearly all central banks worldwide are led by a panel, or a Board of Governors. There is often one Governor who is the spokesperson for the Bank and the representative of the entire Board of Governors. In this context, I wish to mention that, although the Nordic central banks differ in their administrative structure and governance practices, each of them has a Board of Governors.

The broad-based authority invested in the Governor of the Central Bank of Iceland is highly unusual and is virtually non-existent elsewhere. It has been said that we have one Prime Minister and that there are special arguments that apply as well to Central Bank governors. But it should be noted that our Cabinet functions on the basis of representative government, and while it does not have a panel structure *per se*, it divides its tasks in a predetermined way. Externally, it is the Prime Minister who represents the Government – just as the Chairman of a three-member Board of Governors would do as Governor of the Central Bank.

Those are the main findings in the matter. This does not mean that the committee recommends reverting wholesale to the previous structure; the appointment process, for instance, is tightened based on impartial rules on qualifications. But in essence, the committee recommends that the Central Bank be overseen by a Board of Governors.

The recommendations are presented following thorough study and consultation with the Central Bank, the IMF, and other stakeholders, including the political parties. Actually, it can be said that the procedure used to amend the Central Bank Act in such haste in 2009 represented a gross attack on the Bank's independence. The proposals that have been presented take account of what has been done well in the Bank, what other countries' experience has been, and what could be improved. These are important points that I take into account when I

look ahead and consider how to strengthen the framework and independence of the Central Bank of Iceland and simultaneously bolster the credibility of Icelandic economic policy.

Honoured guests:

I mentioned the weather at the beginning of my speech today. That is quite appropriate to a discussion of Iceland's economic situation.

We cannot control nature, and we must live with and brace ourselves against a variety of treacherous conditions – even on a daily basis. But we can prepare for headwinds and stormy weather, and we can arrange our travels so as not to sit stuck on Hellisheiði when we've been warned that a storm was coming and the road would be closed.

The same applies to the economy. We can adopt better, more thorough economic policy work habits, exercise discipline, and make our plans and objectives for the long term, thereby laying the foundation for a stable environment for further progress in all areas – for the benefit of society as a whole.

It is and will be a demanding task. It will always be difficult to cope with economic volatility, catch failures can always occur, and foreign market prices may fall at any time. But by preparing for future volatility during upswings – by making hay when the sun shines – we can ride out the winter and promote enhanced stability and increased well-being for the long term.

This is the most successful way to make steady improvements in the living standards of the people of Iceland. We have already taken important steps

towards strengthening our foundations, and we are on the right track. We should continue to walk this path, one secure step at a time, remembering that *slow and steady wins the race*.

In closing, I would like to close by thanking the Supervisory Board, the Governor, and the staff of the Central Bank of Iceland for their excellent work during the year.

Thank you very much.