

March 31, 2009

The recovery of the Icelandic economy

The Icelandic economy has been undergoing severe difficulties, but with measures now being taken and those that are being prepared, it is my belief that the basis for recovery is now being put in place. As I said in my address on February 27, the day of my appointment, while Iceland is now seen internationally as a symbol of how hard the financial crisis can hit a country, I do hope and believe Iceland can ultimately become a symbol of rapid economic recovery. The experience from the Norwegian banking, currency, and debt crisis in the early 1990s and from the Swedish State debt crisis in the mid-1990s tells me that such a turnaround is possible.

The prerequisite, however, is joint and forceful action, and many elements must be put into place. Daily debate tends to focus separately on each of many elements, and it is dominated by the events of the day. Therefore, I consider it useful to provide an overview so as to facilitate open discussion of economic and monetary policy.

As I see it, four elements are critical to laying the foundation for recovery (see chart): 1) Adjustment of the macro economy, 2) Monetary policy aimed at stability, 3) Fiscal budget adjustments, 4) Re-establishment of a functional financial system.

As regards the first of these, inflation is subsiding rapidly. Inflationary pressures appear to have dampened, and the Central Bank expects inflation to approach 2.5% in early 2010. With respect to the second element, the focus is to facilitate increased stability while lowering interest rates as stability permits. An initial reduction of one percentage point was decided by the Monetary Policy Committee of the Bank on March 19, and a new meeting has been scheduled for April 8. In light of the challenging debt situation for households and companies, which have a mix of indexed and foreign loans, we place priority on reducing inflation and stabilising the króna.

Over time, the Icelandic State's deficit must be turned around into a surplus. Similarly, the negotiation processes in the financial sector and the restructuring and recapitalisation of the banks must be pursued according to plan. The successful functioning of the economy hinges on sound financial institutions with strong liquidity.

The coming months are critical and will be challenging as Icelandic authorities, companies and institutions deliver on the above tasks. However, the prize to be won is large as changes are made, processes completed and plans put in place. Data will show that the State debt has increased significantly from before the crisis. Still, the net debt level of the Icelandic State will probably be close to the European average and, as such, provides no obvious reason for the relatively high risk premium on Iceland. In parallel, the basis for a restructured banking system will be established. These changes are expected to be in place before the summer.

With this groundwork completed, it is time to look ahead. Resources for growth will be available, and growth to support a solid surplus on the current account must be a priority. Foreign-denominated borrowing by companies, households and banks has led to a significant accumulation of debt for the country – debt that must be serviced.

The good news, as you are well aware, is that Iceland benefits from one of the most competent and hard-working populations in Europe. The country benefits from a world-leading fishing industry, an excellent basis for tourism, renewable energy and renewable energy-based businesses, and a much more diversified economy than is apparent when seen from abroad.

With the right actions, we should therefore be confident that a new foundation for growth can be established. Clearly, these are challenging times for all, and the global currency crisis makes the path to recovery rockier and adds significant uncertainty to the whole process.

The Central Bank is responsible for some of the policy areas mentioned above, monetary policy in particular. In addition, while building on its role and its independence, as provided for in the Central Bank Act, the Bank will co-operate as much as possible with institutions, businesses, and other Icelandic authorities in paving the road towards new growth and stability.

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Central Bank of Iceland