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Speech

Már Guðmundsson, Governor of the Central Bank
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Madame Prime Minister, Madame Chairman, honourable Ministers, honourable Ambassadors, ladies and gentlemen:

As we gather here for this 49th Annual General Meeting of the Central Bank of Iceland, the Icelandic economy is still recovering from overheating and the shocks of the recent past. The contraction in the economy is a part of this process, but it is rooted in three things. First, it was inevitable that the enormous expansion characterising the Icelandic economy in 2005-2007 should subside. In line with previous experience in Iceland and other countries, it was highly likely that this would occur through a sharp drop in exchange rate and asset prices, followed by a temporary contraction in business activity and employment. Second, the Icelandic economy sustained severe blows as a result of the worldwide recession in late 2008 and early 2009. The third cause was the collapse of the Icelandic banks in the fall of 2008. When the banks failed, assets were lost, and Iceland’s relations with the international financial system were severely damaged. They remain damaged to this day, as our capital controls bear witness.

The question of how to quantify the proportional contribution of these three causes to our current economic hardships is a persistent one. But no conclusive answer is yet on the horizon – and certainly not now, when so much has yet to be revealed – as the contraction is not over and the effects of the currency crisis and banking collapse are still in evidence. It is clear, however, that 2009 and 2010 would have been difficult for the Icelandic economy in any case, whether the international banking operations headquartered in Iceland had developed or not. This is a most necessary reminder that we must not only clean up the financial market regulatory framework and improve supervision, as I will touch on later, but we must also make efforts to ensure that economic policy prevents macroeconomic imbalances from developing once again.

The Icelandic authorities are faced with a host of challenges that are rooted in the circumstances I have just described. I would like to focus on three of these. First, it is critical to allow the economy to adjust without allowing inflation or unemployment to become entrenched. The goal is a situation in which economic slack has disappeared, GDP growth is in line with growth in production, inflation is at target levels, and the external position of the economy is sustainable. Second, we must establish a financial system that serves Icelandic households and domestic business activities and is both economical and relatively secure. The third challenge is that of re-establishing confidence abroad in Iceland's institutional framework, economy, and financial system; repairing the relationship with the international financial market; and ensuring that the Icelandic Government and Icelandic companies have access to foreign credit markets once again.

I will touch on these three tasks later, but first I would like to shed some light on where we are in the adjustment period I mentioned earlier, and what the immediate future could have in store. First, the contraction in GDP to date has been less pronounced than was forecast early in 2009. The same can be said of unemployment. On the other hand, the króna depreciated more than expected, and inflation has proven more persistent. The Central Bank's January forecast assumed that GDP would contract by 10% between 2008 and 2009, while the most recent figures indicate a contraction of 6½%. On average, the króna was some 15% weaker than was forecast at the beginning of the year. For this reason, among others, inflation was higher than projected, or just over 6% in the first quarter of 2010, excluding tax effects. The January 2009 forecast assumed that we would already have attained the 2½% inflation target by now.

These deviations stem from a variety of sources other than normal forecasting errors. First of all, measures have been taken to support households, and these measures have reduced the contraction in private consumption. Among these measures are a significant increase in mortgage interest allowances, various measures to reduce debt service, and private pension fund payouts amounting to 2½% of GDP. Second, a lower real exchange rate stimulated exports, as well as the sectors that compete with imports. Third, corporate financial restructuring was delayed, and while this is negative for the long term, it delayed the side effects that often accompany such measures and which generally emerge in a temporary contraction and elevated unemployment levels. Fourth, it can be expected that, under the circumstances reigning for most of 2009, the Icelandic export business would have been at an advantage. When uncertainty paralysed the world's consumers after the financial crisis peaked in the fall of 2008, it was simply more advantageous to export aluminium, fish, and tourism than cars and flat screens. Elevated inflation was primarily due to a lower exchange rate and more robust domestic activity than had been expected.

To an extent, these effects were temporary and will be reflected, in part, in less economic activity in 2010 than would otherwise have been the case. This applies, for example, to corporate financial restructuring and, to some extent, pension savings payouts. In this context, it is important that fiscal consolidation measures will be implemented this year, while automatic fiscal stabilisers were allowed to work largely unhindered in 2009. As a result, it is assumed that GDP will contract year-on-year in 2010. How much it will contract is uncertain, however, particularly because investment remains undetermined, largely due to uncertainty about access to foreign credit.

The adjustment following the overexpansion of recent years has run its course, for the most part, and in some areas it has overshot the mark. If we include the Central Bank's forecast for 2010, public expenditure has contracted by nearly one-third since 2007, which is virtually unparalleled in other countries, as other countries did not experience the overheating Iceland did. Iceland's huge current account deficit has turned to a surplus, excluding calculated interest in the estates of the failed banks, which may not be paid. The plunge in the currency has been arrested, and other things being equal, inflation will fall sharply in the next few months. The latest inflation measurements, published earlier this week, change nothing in this regard, as they were foreseen by the Central Bank, and because the year-on-year rise in inflation is due largely to the drop in the CPI in March 2009.

A number of economic variables have now overshot the mark, as often happens when imbalances like those in Iceland correct themselves. The most important of these is the real exchange rate of the króna, which is currently one-third below its historical average and probably considerably below its long-term equilibrium. The real exchange rate will therefore rise in the quarters to come. It is the role of monetary policy to ensure that the nominal appreciation of the króna as a share of the real exchange rate rise is conducive to bringing inflation down to target by the time the adjustment is over.

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The economic policy framework is determined by the collaboration between the authorities and the International Monetary Fund (IMF). According to the IMF programme, the main task of monetary policy at the outset was to arrest the fall of the króna and then promote exchange rate stability, but without formally resorting to a fixed exchange rate regime, as it was considered desirable that the króna should appreciate afterwards. This strategy was triggered by the currency crisis, which has sent the exchange rate far below the levels previously thought likely, let alone desirable, and by the large share of exchange rate-linked loans in private sector debt. The problem, however, was that achieving exchange rate stability with conventional tools, such as interest rates and foreign exchange market intervention, would require astronomical interest rates and/or larger foreign exchange reserves than Iceland had, partly because of foreign investors' large holdings in krónur. As a result, it was decided to impose temporary capital account restrictions, in the hope that they would provide monetary policy with the elbow room to base its decisions on the slack in the economy while establishing exchange rate stability. Another goal was to create some shelter for private sector debt restructuring.

This strategy has delivered considerable results. The króna has been relatively stable since mid-2009 and has actually appreciated a bit in recent weeks, although it has slid somewhat in the past few days. At the same time, the Central Bank stepped down its sales of foreign currency in support of the króna and has not intervened in the FX market since early November. In part, this is due to the fact that the króna was already very weak, and the underlying trade surplus has since provided the króna with a stronger foundation. But one cannot ignore the most important explanation: with the changes to the capital controls that were announced in end-October/early November 2009, and the expansion of the Capital Controls Surveillance Unit staff, the controls are finally working as originally planned. Most important here is the fact that the link between the onshore and offshore markets for krónur has been largely disconnected.

This also appears in a significant drop in inflation. In the first quarter of 2009, price levels excluding tax effects had risen by nearly 17% year-on-year. The corresponding figure for the first quarter of 2010, however, is just over 6%. In the absence of further shocks that weaken the króna once more, there is a very good chance that inflation excluding tax effects will be close to target by the end of the year. The Central Bank has cut interest rates substantially. The Central Bank interest rate that made the greatest impact on other rates was 17% a year ago, when the Bank held its 2009 Annual General Meeting. As of today, the corresponding interest rate – the average of current account rates and the highest CD rates – is just over 8%.

But although interest rates have fallen significantly, it cannot be denied that they are still higher than desirable in view of the slack in the national economy, and they could be lower if the inflation outlook were the only criterion. This is the price we pay for the currency and banking crisis, the lack of credibility in foreign capital markets, and the limited access we have to those markets. Simply put, Icelandic interest rates include a large risk premium. If the capital controls are effective, as they appear to be at present, they obviously provide some scope to look beyond this risk premium. But the controls have not yet been tested by sharp and deep reductions in interest rates and a smaller interest rate differential with abroad than currently exists. Until now, there has been no occasion to take interest rate decisions based on the assumption that no steps will be taken to lift the capital controls in the near future. We hope no such circumstances develop.

Strictly speaking, monetary policy in Iceland is not following the inflation target at present. But as the weight of exchange rate-linked items in domestic balance sheets declines, and as confidence rises and the foundations for the exchange rate itself are strengthened, monetary policy can devote greater attention to the slack in the economy and the inflation outlook. In this context, three factors are most important: returning domestic financial institutions to full functionality, converting foreign-denominated debt to domestic currency, and restoring access to foreign credit and financial markets.

It is important to enhance the effectiveness of the Central Bank's monetary policy instruments and improve the transmission mechanism of monetary policy. While confidence in the financial market remains limited, the Central Bank's policy instruments will not be fully effective because, under these circumstances, financial institutions have every reason to consider it more beneficial to do business with the Central Bank than among themselves. The Central Bank has set a framework for the money market, foreign exchange market, and bond market, thereby contributing to their resurrection, in co-operation with the authorities and the financial institutions. At this point in time, it is primarily the bond market that has shown signs of recovery. However, financial institutions' conduct still shows that they are uncertain about the future, and the premises for trading are distorted to some degree. Finding a solution to this will be an important task in the coming months.

At present, investment in Iceland is close to a post-WWII low. According to the most recent forecast, it can be assumed that investment as a share of GDP will be under 14% in 2010, the lowest ratio since the end of the War. Exports can drive GDP growth for a while, but a lasting recovery and stable growth require a reinstatement of investment in value-generating commercial activities. Domestic interest rates have been blamed for the sluggishness of investment activity, and certainly, financing costs are an important factor in investment. Under current circumstances, however, it would be fantasy to maintain that a sizeable interest rate cut would catalyse a turnaround in investment. Considering how strong investment was during the upswing years, the Bank's surveys show that current investment trends in Iceland are similar to those in other countries that have experienced financial crises. Furthermore, it should be borne in mind that business investment is minimal in most industrial nations at present, even though their interest rates are very low. Risk aversion in the wake of financial crisis and economic recession, together with uncertainty about future demand, are hurdles to investment. The Central Bank's studies and informal surveys indicate that the same situation prevails here in Iceland. Added to this are heavy indebtedness, uncertainty about companies' future operational environment, and limited access to foreign credit. Consequently, it will require more than interest rate cuts to stimulate investment.

Decisions on the level of monetary policy restraint are always taken under conditions of uncertainty – about the current economic situation and probable future developments, and whether monetary policy instruments will be effective at any given time. This is why responsible and well-informed parties can easily disagree on what is the best course of action at any time. In the Central Bank's *Annual Report*, which is available for perusal here, you can see how individual members of the Monetary Policy Committee voted at the various meetings in 2009. The minutes of the MPC meetings reflect the in-depth coverage of economic affairs at each meeting and the issues the Committee deals with at any point in time. I take the liberty of asserting that all MPC members vote as they deem most appropriate in view of current circumstances and the Committee's objectives. Moreover, I strongly doubt that interest rate decisions based on some other arrangement, where professional views are less important and transparency less, would yield better results.

Under the current circumstances, however, decisions on the level of monetary policy restraint are more complex than they generally have been in the past. That complexity stems in part from the fact that it is not clear where we are headed in the immediate future. Will access to credit markets be restored in the near future, so that we can strengthen our foreign exchange reserves and begin lifting the capital controls soon, without jeopardising the exchange rate of our currency or worrying about upcoming payments on the Treasury's foreign loans in the winter of 2011-2012? Or are we faced with a situation where access to foreign credit remains limited and the capital controls must stay in place much longer than we had hoped? It will then become critical to eliminate this uncertainty.

If the conclusion is that we must maintain the capital controls longer than originally intended, and if access to further foreign credit is not forthcoming except at usurious rates, we will have to draft an economic policy that takes account of these circumstances. In that instance, strong emphasis would be placed on preventing the nation's foreign exchange reserves from becoming dangerously depleted following payments on Treasury loans in the winter of 2011-2012. Fiscal policy would have to be tighter than is currently planned. As regards monetary policy, two factors would tend to offset one another: the economy would be weaker, but the exchange rate would be lower. The more effective the capital controls are, however, the lower interest rates can be. This could also mean that the Central Bank would purchase foreign currency in the market in order to strengthen its reserves in advance of the loan payments, and that, in turn, would mean a lower exchange rate. Because we have a certain amount of time on our side, it is not likely that this will occur in the next few weeks unless the króna begins appreciating markedly.

On the other hand, it is difficult to see how such a programme could continue without collaboration with the International Monetary Fund and others, as the capital controls are based on emergency authorisations in the EEA Agreement and are contrary to the spirit of Iceland's agreement on OECD membership and Article 8 of the IMF Articles of Agreement, to which Iceland has agreed. Furthermore, it must not be forgotten that collaboration with the IMF bolsters foreign markets' confidence, and Iceland has benefited greatly from the technical assistance of the Fund's staff during the course of the economic programme.

It is my view that, if the requisite conditions develop in the near term, we should try to lift the capital controls as soon as possible. They have played an important role in the progress that we have made. The associated cost has probably been lower than they might have been until now because other factors have obstructed trade and international co-operation. But as time passes, the cost – in terms of all sorts of disadvantages and lost business opportunities – will rise.

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I have expounded at length on monetary policy, the capital controls, and the IMF programme, as these topics have been at the forefront of public discussion recently. But am I painting too black a picture? What is the outlook for Icelanders' foreign debts and re-financing needs in the next few years? This subject has been discussed repeatedly in the recent past, and opinions vary. Some go so far as to maintain that the economy will collapse under the weight of its debt and the Treasury will become insolvent. Fortunately, a careful analysis of the available information reveals this turn of events to be unlikely.

There is still considerable uncertainty about what the Icelandic economy's net external position will be once the air clears after the fall of the banks. Currently underway is a process involving writing down the private sector's external assets and liabilities, with offsetting transactions in many instances because of bankruptcy proceedings. According to official balance of payments figures, Iceland's net external liabilities amounted to 5.6 trillion krónur at the end of 2009, or nearly four times GDP, and about 0.4 trillion krónur without the failed banks, or just under one-third of GDP.

The underlying position that can be expected to emerge once the dust has settled will probably lie somewhere between the position excluding the failed banks and the position that reigned in Iceland during the decade before the crisis. The exact result will depend, among other things, on the distribution of domestic and foreign creditors in the creditor group and the classification of the old banks' assets as domestic and foreign. The Central Bank has made regular efforts to assess this. In December 2009, the Bank issued an opinion concluding that the underlying net external position could be around 90% of GDP. The most recent surveys indicate figures closer to 80%, including the most recent estimate of the Treasury's net obligations due to minimum deposit insurance for British and Dutch online branches of Landsbanki; however, because no contractual agreements have been finalised, this is still subject to uncertainty.

This is lower net debt than Iceland has had since late 2005, and is certainly manageable. But this figure is still subject to uncertainty. Central Bank staff members will therefore continue to clarify the picture and are currently at work on a report on the Icelandic economy's foreign assets and liabilities.

Net debt is important in the assessment of an economy's debt sustainability and in comparisons with other countries' indebtedness. On the other hand, gross debt is important as well, especially as regards re-financing needs and potential pressure on the exchange rate of the króna. In this context, it is important to consider whether the debt is generated by the private sector or the Treasury, or by firms with a Treasury guarantee. Significant private sector re-financing needs that cannot be funded with new loans can exert pressure on the exchange rate, which in turn can have a negative effect on other debtors with foreign-denominated debt, but they will not cause national insolvency. If households or businesses cannot pay their foreign-denominated loans, they become bankrupt, and the debt is written down at the expense of the foreign creditor. If the Treasury ends up in that position, however, it could have serious repercussions for the nation's access to foreign credit markets and the financing terms available for the long term. It is important to avoid this, and it should be possible, even if Iceland's access to foreign credit remains limited. In this context, it is of key importance that the foreign exchange reserves be large enough to support the Treasury's upcoming loan payments, which amount to roughly 1½ billion euros in the winter of 2011-2012.

The Central Bank's foreign exchange reserves totalled just over 480 b.kr., or 2.8 billion euros, at the end of 2009. This amount has changed little since then. The reserves amounted to nearly one-third of GDP and just over 14 months' worth of imports. By that measure, these are the most sizeable foreign exchange reserves that Iceland has "owned" since the end of World War II. "Owned" is perhaps not the right word, however, because our current foreign reserves consist largely of borrowed funds, while we owned our post-WWII reserves debt-free. In all, loans taken in the past few years for the express purpose of strengthening the reserves, plus the Central Bank's foreign exchange deposits owned by parties other than Government entities, total 3.8 billion euros, or 1 billion euros more than the reserves.

The resolution committees of the failed banks have Central Bank deposits totalling nearly 1 billion euros. Those balances will be paid out in the months and years to come. If they are deducted from the reserves, together with other funds that will likely be withdrawn in the next 12 months, there are 1.4 billion euros left. This is sufficient to cover the instalments that must be paid on the Treasury's foreign loans in the winter of 2011-2012, which total 1.4 billion euros. But the foreign exchange reserves would then be exhausted, and the situation would be difficult, to say the least. On the other hand, this will not be allowed to happen. In my opinion, if such a situation appears imminent, we must take action according to Plan B, which I discussed earlier. In addition, it is highly likely that we will be successful in realising some of the foreign claims held by Central Bank of Iceland Asset Management.

I would like to take this opportunity to announce for the first time that, in recent months, the Central Bank has purchased, on the secondary market, bonds from the series maturing during the winter of 2011-2012. The purchase has a nominal value of 116 million euros and was executed on favourable terms. Because of this transaction, the reserves can now cover the loan payments. Furthermore, it will end up reducing the Treasury's foreign debt at lower expense than would have been achieved otherwise.

If we gain access to the remainder of the loans from the IMF and the Nordic countries, it will be possible to strengthen the reserves by another 2½ billion euros. The reserves would then amount to 3.9 billion euros, almost half of GDP and nearly 21 months' worth of imports, before the loan payments. Of course, this is a much larger reserve fund than we need for the long term, and it will be costly. For this reason, we will continue to refine our projections of how much, and when, we need these supplemental loans. In this context, we must also bear in mind that we will only need maximum foreign reserves for a short period of time, while we are setting the stage to lift the capital controls and getting beyond these large loan instalments.

The Central Bank has decided, in connection with its macroeconomic forecast this coming May, to prepare a new balance of payments estimate for next year, as circumstances have changed somewhat since the last such estimate was prepared in connection with the IMF economic programme. Then it will be easier to assess what kind of pressure instalments and interest payments from all Icelandic parties could place on the króna in the months to come if nothing else changes, and our need for foreign exchange reserves will be further clarified as well. One thing is clear, however: for a period of time, we will need to maintain larger foreign reserves than we currently do.

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The resurrection of the financial system is well advanced, and the capital base and ownership structure of the new banks have been determined. The next step is to complete the financial restructuring of the savings bank system. The Minister of Economic Affairs has presented a bill of legislation on financial undertakings, which addresses a number of the shortcomings that emerged in their operations during the run-up to the crisis, including large exposures, related party lending, and owner eligibility. A number of projects must be tackled afterwards. The banking system is still too large for domestic needs. Our financial institutions are operating in the shelter of capital controls, and the future arrangements for their links to foreign financial markets are still undetermined. Furthermore, many domestic financial institutions have sizeable currency mismatches between their foreign assets and liabilities. This is risky and increases their need for capital. The financial institutions themselves will have to work diligently in order to reduce the imbalances in their currency composition, but because the hedge market is not functioning properly at present, it is possible that the Central Bank might assist them in repairing their foreign exchange balance through swaps with institutions that have an opposite mismatch. In addition, the Bank will soon review its precautionary rules on financial institutions' liquidity and foreign exchange balance, in light of recent events.

The Central Bank of Iceland has collaborated with savings banks and the Ministry of Finance on a solution to the recapitalisation of the savings banks. The solution involves settlement of a large portion of the claims that the Central Bank received as compensation for deposits transferred to it, in accordance with the decision of the Financial Supervisory Authority (FME) on the disposal of assets and liabilities of Sparisjóðabanki Íslands hf. (SPB) in March 2009. The settlement of the compensation has not been finalised, however, and the matter is still being considered by the Financial Supervisory Authority. The Central Bank has concluded agreements with eight savings banks concerning the settlement of claims, and the agreements will be finalised soon after the Financial Supervisory Authority and other creditors have confirmed them. I realise that it is painful for guarantee capital owners and creditors to lose these assets, which were deemed quite valuable before the crash and were perhaps purchased recently with borrowed money. Nonetheless, it is necessary to face facts and try to salvage the value that remains. I have always viewed the savings banks as an important part of a healthy financial system, as they have a certain advantage in assessing local opportunities and risks and are generally trusted in their home communities. But this makes it important that the savings banks limit their activities to the areas where they can compete, and not extend into risky investment banking operations. With the financial restructuring currently underway, it will be possible to strengthen the foundations of important savings banks. Many of them will remain in operation, and their guarantee capital owners will have an opportunity in the future to repurchase a stake in them from the Government. Although writing down guarantee capital now is painful, it is a far less drastic measure than the shareholders of the failed banks were faced with. On this occasion, I would like to encourage all savings bank investors and employees to take this opportunity to begin building their savings banks for the future.

For the most part, domestic payment intermediation withstood the shocks of 2008 and 2009, but the same cannot be said of cross-border payment intermediation, as Icelanders discovered in the fall of 2008. The Central Bank plans to work with financial institutions and the appropriate authorities in the next few weeks, with the aim of reducing risk in payment intermediation. Furthermore, it is necessary to consider strengthening infrastructure and separating infrastructure from competitive operations.

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Honoured guests. This is neither the time nor the place to conduct an in-depth analysis of the Icelandic financial crisis. We are now awaiting the release of the report from the Parliamentary Special Investigative Commission, which presumably will generate extensive discussion. We hope that discussion will aim at getting to the bottom of the matter: determining what went wrong and suggesting improvements. Although a great deal remains unknown about what happened in the financial institutions that collapsed and in the preparation of Government responses before and after the crisis struck, we also know a great deal about what was lacking in regulatory framework and supervision – particularly the elements that Iceland shares with many other countries. In the international arena, there has been extensive discussion of the flaws in regulation and supervision, and improvements are being implemented already. The Central Bank of Iceland is keeping close track of this work, not least through its membership to the Bank for International Settlements in Basel and its collaboration in European and Nordic fora.

To my mind, the most important weaknesses in this regard – and they are not limited to Iceland – are the following:

First, too much attention was paid to risks in individual institutions, while a comprehensive assessment of risk in the financial system as a whole was much less developed. The old adage – that the whole is greater than the sum of its parts – was forgotten.

Second, the institutional framework was flawed, in that it did not promote such a comprehensive assessment of risk. It was unclear who was responsible for responding to systemic risk, and there were too few tools for addressing it, such as variable capital requirements and other restrictions to combat lending and asset bubbles and set limits on risk appetite.

Third, liquidity risk was underestimated, not least risk related to liquidity management between currencies and financial institutions' re-financing in foreign currency.

Fourth, actual equity in the financial system proved too little to offset the indebtedness and other risk that had accumulated.

Fifth, the regulatory framework for cross-border banking operations was deeply flawed, not least in the European Economic Area.

Sixth, there is significant risk associated with building a relatively large banking system with cross-border operations based on a small country and small currency.

These problems remain more or less unaddressed here in Iceland, and as a result, there is little in the regulatory environment to prevent the problems Iceland had before the crisis from developing once again, although it is unlikely that this will happen in the next few years, as our financial systems are still recovering and risk awareness is keen. Now is the time to solve these problems because, if we wait until operations have resumed their full pace, it might be too late, and the will and incentive to take action will be lacking. The Central Bank is determined to set policy on these matters during the current year, and to contribute to joint policy-making with the Government. This process involves, on the one hand, macroprudential rules – that is, rules that reduce systemic risk and obstruct the development of credit and asset bubbles, and on the other, it involves institutional elements, not least possible forms of closer collaboration or merger between the Central Bank and the Financial Supervisory Authority.

And monetary policy will be reviewed as well. There is a practical reason for such a review: we need to formulate the monetary policy that will take over from the IMF programme because the current arrangement will not suit once the capital controls have been lifted and Iceland has re-established its financial links with other countries. But there are also lessons to be learned from monetary policy implementation during the upswing and in the run-up to the financial crisis. The inflation target and the floating exchange rate did not cause the banks to collapse; after all, if they had, many more banking systems around the world would have fallen. But monetary policy was part of the chain of events here in Iceland, and a number of difficulties emerged in monetary policy implementation under the conditions then reigning. There will be opportunities to discuss this in greater depth later, but in my view, the inflation target as such was not the problem, as studies show that countries with inflation problems are likelier to be hit by banking crises, and fare worse in the event of such a crisis, than their counterparts without problem inflation. The problem was rather that the various elements of economic policy did not interact as they should have, and it has come to light that implementing a floating exchange rate regime is complex and difficult in very small, open economies with strong financial ties to other countries. It will be necessary to reassess ideas based on clear boundaries between monetary policy and financial stability policy, and consider more deeply the particular risks associated with a small, unstable currency. All of these points will be considered with an open mind, and the Bank intends to examine two options thoroughly: The first is participation in the European Monetary Union. The other focuses on the monetary policy options available to Iceland if it remains outside the EU and the EMU. The latter of these could also be useful during preparation for EU and EMU membership, if it comes to pass. The Bank aims to complete an interim report early this summer, and an in-depth report early in 2011.

This re-examination of policy pertaining to financial and monetary stability could require a review of the Central Bank Act, which I think is needed in any case. Consequently, I welcome the Minister of Economic Affairs' statement, earlier in this meeting, that he intends to push for a comprehensive review of the Central Bank Act. I consider it critical that attempts be made to achieve as much multipartisan consensus as possible about that review.

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Honoured guests: The affairs of the Central Bank of Iceland were administered by the Prime Minister's Office until this past fall. I would like to take this opportunity to thank the Prime Minister and the Prime Minister's Office for successful collaboration during that period. I would also like to thank the Minster of Economic Affairs and his Ministry for successful co-operation in recent months. I want to extend my thanks to other Ministries and institutions as well, not least the Financial Supervisory Authority and the Ministry of Finance. Other collaborators, including financial institutions and non-governmental organisations, and the staff of the International Monetary Fund, also deserve thanks for their co-operative efforts. And last – but certainly not least – I would like to thank the employees of the Central Bank for their work. Without them, there would not be much wind in my sails today.

And in closing, I wish to say this: Iceland has been faced serious economic difficulties in the recent past, and there are certain dangers ahead. But we have the power to steer clear of them. We could be at the bottom, poised to rise up again and move forward, if we play our cards right. But we must ensure that we avoid turbulent waters and establish long-term stability. In order to do so, we must demonstrate the patience and resilience to allow the recovery of the economy and the financial system to play out. History teaches us that pride goeth before a fall – but it also teaches us that the darkest hour is just before the dawn. Let us bear that in mind as we welcome the spring.