

Address to the 48th Annual Meeting of the Central Bank of Iceland

by

Governor Svein Harald Øygard

(Spoken word prevails – talað orð gildir)

Honourable Prime Minister, Ministers, Chairman of the Supervisory Board, Ladies and Gentlemen:

I welcome you all to the 48th Annual Meeting of the Central Bank of Iceland.

As the Chairman of the Supervisory Board has stated, the Bank's annual accounts, ratified by the Prime Minister, are available here, as is the *Annual Report* for the year 2008.

2008 was an extraordinary year, not only for the Central Bank, but for the economy of Iceland as a whole and for the global economy. I am not going to review the unfolding of the financial crisis and actions taken in the wake of it.

Reports on the history of those events have been made public, and there will be more to come. One will be the Central Bank's *Financial Stability* report, due in October of this year. Employees of the Bank are also assisting the Investigative Committee on the Banking Crisis and the Special Prosecutor to the extent possible.

I would like to point out, however, that our payment systems and domestic payment intermediation withstood the strain of the crisis. Over the past several years the Central Bank has incorporated security measures, such as collateral and technical locks, into the principal domestic systems. These improvements minimised counterparty and settlement risk in the systems, enabling them to remain fully operative in spite of the enormous strains of the October crisis. Cross-border payment intermediation posed serious problems, but the Central Bank was able to facilitate payments for the banks and their customers by using its own accounts and credibility. This capability was called for again this March, when three more banks became late victims of the October crisis.

Payment systems are often regarded as a technical and even mundane subject. People assume that they can always access their accounts and make payments domestically and across borders anytime they need to do so. This is as it should be in a well-functioning modern economy. In a financial crisis situation, however, when uncertainty and counterparty risks dominate, it is no small accomplishment to keep payments flowing.

In this and other areas, the employees of the Central Bank and the partners with whom we cooperate made an extraordinary contribution.

In my address today, I wish to focus on the future, not the past, and especially on what now needs to be done to stabilise the Icelandic economy and prepare the ground for recovery. Specifically, I will highlight some areas where, in my view, action is imperative and issues must be resolved.

Despite an ever broader and deeper global recession, Iceland is still referred to internationally as a symbol of how hard a financial crisis can hit a country. This represents a challenge on top of all our other challenges, and it accentuates the need for a clear vision and for tangible progress.

Once we have established a clear vision and demonstrated our ability to deliver, Iceland should have the basis for becoming a symbol of how quickly an economy can recover. In my view, we should aim for no less.

Such a change of sentiment may be difficult to achieve, but it is essential in order to support investments in Iceland and revive export-led growth.

The Act on the Central Bank of Iceland was amended in February 2009. The amended Central Bank Act stipulates that monetary policy is to be decided by the Bank's Monetary Policy Committee, which includes three representatives from the Bank and two external members, both of them professors of economics. I would like to take this opportunity to thank the external members, Anne Sibert and Gylfi Zoega, for their extremely valuable and insightful contributions to the Committee's discussions.

The recession and the weakening of the króna since early 2008 have hit businesses and households extremely hard. Given the formidable debt situation faced by households and companies, which have a mix of indexed and foreign currency-denominated loans, the MPC places priority on reducing inflation and stabilising the króna.

Inflationary pressures appear to have subsided and inflation is declining rapidly. The Central Bank expects inflation to approach the 2.5 percent inflation target in early 2010.

Capital flows are a huge challenge for all economies, especially small, open economies. Capital inflows and the associated appreciation of the króna accentuated the imbalances leading up to the financial crisis.

We are now faced with a number of investors who wish to sell ISK-denominated assets. Capital controls have therefore been in place since November 28 and were tightened in late March. The Central Bank is now stepping up further its surveillance of the regulatory framework and is establishing a new surveillance unit. Rules are being amended so as to require that banks flag transactions that may be non-compliant, in a manner similar to the EEA rules on money laundering.

Because they prevent disorderly capital outflows, capital controls are an unfortunate but indispensable element of a strategy aimed at protecting balance sheets and promoting sustainable recovery. They also provide some additional scope for relaxation of monetary policy.

The real economy calls for significant easing of monetary policy, and some first steps have been taken by the MPC, through its policy rate decisions of March 19 and April 8.

Nevertheless, high interest rates are still deemed necessary – until mechanisms to ensure greater fundamental stability have been put into place.

Monetary policy makers are faced with a difficult trade-off: immediate easing of monetary policy, with the associated risk of instability; or having to expose a real economy in need of lower interest rates to rates that are high by international comparison.

Some argue that high interest rates, among other things, lead to high interest payments on non-residents' ISK holdings and that the medicine merely increases the fever. Accordingly, they assert that lower rates would reduce interest payments and thus strengthen the króna and reduce the burden of high interest rates on households and businesses.

It should be noted, however, that only a sub-set of non-residents' ISK holdings accrue interest that is linked to the Central Bank policy rate. Hence the reduction of interest payment outflows will be less than is expected by many. Furthermore, these ISK investments held by non-residents, although sizeable, represent only a fraction of the foreign-denominated loans of Icelandic businesses and households. Pursuing the suggested approach will therefore represent a sizeable risk for many.

Fortunately, a less risky option exists.

Given defined timelines, it should be possible to achieve five of the main prerequisites for significant monetary easing over the next few months:

- First: A medium-term budget adjustment plan will be put in place and must engender confidence in Iceland's ability to tackle its public debt situation. The plan will be in line with the best traditions of Iceland, which had the *second-lowest* gross fiscal debt level in pre-crisis Europe. It should be clear to all, independent of political interests, that Iceland – now more than ever – needs fundamentally solid public finances. This priority should rank first among all, for policymakers and for the Central Bank as well. Requests that otherwise would have been approved have to be turned down or not recommended. All efforts should be made to avoid further socialisation of private sector debt, and thus preserve the financial strength of the Republic.
- Second: The restructuring and recapitalisation of the banking system must be completed. All developed countries place great importance on maintaining a well-functioning banking system. Research suggests that a sound financial system is a key ingredient for long-term economic growth. The negotiation processes in the financial sector and the restructuring and recapitalisation of the banks must therefore be pursued according to plan. As part of this, the foreign exchange exposure and indexed loan exposure of the new banks must be addressed. The good news is that important preparations are now about to be finalised.
- Third: With declining domestic demand, there will be resources available to service the country's accumulated debt and pave the way for increased employment in the future. We already see that exports of goods and services exceed imports. The country benefits from a world-leading fishing industry, an excellent basis for tourism, renewable energy and renewable energy-based businesses, and a widely diversified

economy. Iceland is internationally renowned for the flexibility of its economy and the competence of its people.

- Fourth: While current domestic and external circumstances do not yet allow for the removal of capital controls without the risk of instability, the Central Bank of Iceland regularly assesses their effectiveness and is exploring possibilities for their gradual, systematic easing as soon as conditions permit. The Central Bank also reviews selected measures that may allow the most impatient investors locked in by the capital controls to convert their holdings of ISK, in a way that does maintain the currency reserves of the Bank.
- Fifth: Negotiations for bilateral loans, other negotiation processes, and the IMF review should be completed shortly. As early as March 2008, the Central Bank of Iceland requested currency swap agreements with other central banks. Discussions with the three Nordic central banks resulted in the currency swap agreements announced in mid-May 2008. These agreements are now in effect, and I would like to thank the Nordic central banks for their continued cooperation.

While these five processes are being finalised, firm monetary policy supported by effective capital controls will remain in place.

Current monetary policy is guided by the interim objective of stabilising the exchange rate, while the inflation target remains the long-term goal. Still, the króna has been quite volatile through March and April. As stated in the last MPC statement, this has partly been driven by transitory factors, such as relatively large seasonal interest payments on non-resident ISK holdings.

In general, I would say that all key monetary and fiscal priorities over the next year are more or less the same – no matter whether Iceland chooses to follow a flexible exchange rate system based on the króna or to move towards another monetary system such as the EMU.

Still, in an effort to contribute to public discussion, the Central Bank is preparing to update the 1997 report on the establishment and effects of the European Economic and Monetary Union. Similarly, an analytical report on alternative models for flexible exchange rate regimes versus fixed-rate structures – including the EMU – will be initiated. A key ingredient in this analysis will be the question of the role of the króna as a shock absorber versus as an independent source of shocks.

In his recent report on Iceland, Finnish banking expert Kaarlo Jännäri has highlighted the importance of closer collaboration among the authorities on economic and regulatory issues.

I fully support this view. The Central Bank will do its utmost, based on the principles of the Central Bank Act, to drive, support and provide resources for the processes that must be completed over the months to come.

I also believe, in common with Kaarlo Jännäri, that the current situation calls for enhanced integration of the work carried out by the ministries and other authorities involved in economic policy and the financial sector. Although this does not fall within the sphere of the Central Bank, I recommend strongly that the responsibility for such matters be assigned to one, and only one, governmental ministry. This will be particularly important in order to

ensure coordination of effort and assertive implementation of policy actions in the next three to six months.

A well-informed, focused, effective and co-ordinated process will be particularly important for resolving the issues related to the “old”/“new” commercial banks. This should be a priority for all authorities, for the Central Bank, for the creditors, and for the banks and their representatives. Delay is not an attractive option.

Jännäri also proposes that we merge the Central Bank and the Financial Supervisory Authority, or at least bring them under the same administrative umbrella – and that the Financial Supervisory Authority be entrusted with greater discretionary power. The Bank supports this view, which seems to be in line with views increasingly held across Europe. The importance of the Central Bank’s role as the “lender of last resort” has become ever clearer globally – as has its cost and therefore the importance of close interaction between central banks and supervisory authorities.

In closing, I would like to use this opportunity to thank the IMF; the head of mission, Mark Flanagan, the resident representative, Franek Rozwadowski, and all members of the IMF mission for their contributions and commitment. Based on my dealings with them, I am convinced that they place the interests of Iceland and the international financial system at the forefront in all their efforts.

Ladies and Gentlemen:

Important and urgent tasks await us. We need to refine our roadmap for the way ahead. The first task, as I said, is to re-establish the banking system, and the second is to pave the way for stability, including stable inflation and stable finances with appropriate policy, creating a sound basis for economic growth and increased employment. Every month that passes without clarity on the fundamentals hinders new growth. The cost of this to the economy can be counted in billions of krónur per month, and the cost to society can be seen in the suffering of the Icelandic people.

The Central Bank is responsible for some of the policy areas I have mentioned, 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. It is my hope and belief that together we will help Iceland to become a symbol of rapid economic recovery.

Thank you.