Bjarni Benediktsson

Prime Minister of Iceland

Central Bank of Iceland

Honoured guests:

Today I am addressing you for the first time as Prime Minister, after having spoken as Minister of Finance and Economic Affairs at the past three Annual General Meetings. When the new Government was formed, affairs concerning the Central Bank of Iceland were transferred to the Prime Minister's Office. The Bank and the Ministry of Finance and Economic Affairs will still work closely in a number of areas, however. Among them are the financial interactions between the Bank and the Treasury, foreign exchange matters, capital account liberalisation, economic affairs, and interactions with credit rating agencies and international institutions.

The new Government's platform states that the premises for Iceland's monetary and exchange rate policy will be reviewed, partly in response to changes that have taken place in the domestic economy with the significant expansion of the tourism industry and the rapid growth of the foreign exchange reserves. This work has already begun under the leadership of a three-member task force, which will consult extensively with domestic and foreign experts, party caucuses, the social partners, and the university community. The aim is to find the monetary and exchange rate policy framework that, in the long run, will be most conducive to economic and financial stability. The review is based on the assumption that the króna will remain Iceland's currency in the near future, and the objective is that movement of capital to and from the country will be as unrestricted as possible and in compliance with Iceland's international obligations.

It is timely to undertake this work now. It has been a long time since we held a comprehensive discussion of Iceland's monetary and exchange rate options. The inflation target was adopted in 2001 with a declaration from the Prime Minister and the Central Bank, and the Act on the Central Bank was amended accordingly. A great deal of water has flowed under the bridge since then, and the domestic economy has experienced extraordinary highs and lows. During the post-crisis resurrection, there has been little time to examine long-term monetary policy, apart from the Central Bank's in-depth report from 2012 entitled *Iceland's Currency and Exchange Rate Policy Options*. Now, however, the capital controls are behind us and external conditions are unusually favourable. It is therefore the right time for thorough and open discussion of the pros and cons of various options.

There is no magic formula that will mitigate volatility and maintain stability. Options that pose a solution to part of the problem create new challenges and threats in other areas. The króna has played an undeniable role in facilitating Iceland's reconstruction and is recognised internationally as such. The collapse of the króna at the time of the crash improved the competitive position of export sectors and created ideal conditions for Iceland's emergence as a desirable travel destination. Positive shocks such as improved terms of trade and a successful resolution of the balance of payments problem have also helped to strengthen the economy.

The króna has therefore played an important role in the domestic economy. Its strength has been a major factor in the past three years of price stability and real wage growth. Icelanders' purchasing power is at an all-time high both at home and abroad. One only has to convert Icelanders' average wages to euros and compare them to those in neighbouring countries to see how strong Iceland is.

Export sectors face a different reality, however. Their operating environment is not stable, they have absorbed a 25% increase in wages and pension payments in a short span of time, and they have dealt with a strong currency appreciation. Tourism companies, fisheries, innovation companies, and industrial companies operating in international markets see their margins shrinking and their competitive position deteriorating.

All of this is subject to the laws of economics. The króna has appreciated because of Iceland's strong position. Each additional króna that enters the economy

- through the tourist who realises his dream of a trip to Iceland
- through better prices obtained for marine products in foreign markets
- through the stability contributions paid to the Government by the failed banks' estates

makes Iceland stronger, and this shows in a stronger currency.

The challenges we face, then, are positive ones. Since the Speaker of Parliament declared the establishment of the Republic of Iceland at Þingvellir more than seven decades ago, we have never been in a better position economically. It is certainly bold to assert that the Republic has never been in a better economic position, but this vie is supported by a long-term comparison of key economic variables, metrics of economic welfare, and international research. In the opinion of *The Economist* magazine, we are among the fortunate Nordic countries that have managed to create better, more egalitarian societies than have ever existed before. The international community views us as a model community featuring a high level of economic welfare and unusually equal distribution of goods and assets, and governed by equal rights and tolerance.

Our economy therefore stands on stronger ground than before, and our level of economic well-being is high. But could we lose our footing economically? Yes, indeed. The surest way do to it would be through internecine squabbling and excess. Through not using our strong position to build our future. Through being unable to act in our own best interests.

Economic fluctuations are an inalienable part of any society. Lean years are followed by boom years, and vice versa. In earlier times, these fluctuations were determined largely by natural phenomena. In recent centuries, however, economic policy instruments have been developed so as to smooth out these fluctuations. These policy instruments have had a countercyclical effect, but they have certainly not eliminated all cyclical volatility. The position of any given country is also constantly in flux: some countries are stronger than others in the long or short run—they build on solidarity, find new natural resources, or use new technologies—while others lose their way or are beset by severe shocks of natural or human origin. This is simply a part of life.

Mitigating volatility and maintaining stability are desirable things. All governments in Iceland include economic stability as one of the pillars of their policy platforms. They present this ode to stability even though it is known that a small country relying on exports of natural resources must be prepared for greater volatility than large countries with a stable base of industrial manufacturing. But they put these stability provisions forward in order to achieve the necessary consensus on the application of economic policy instruments to mitigate fluctuations rather than amplifying them.

We could do better in terms of mitigating fluctuations. One of Iceland's greatest advantages as a nation is that its people are highly industrious, quick to adapt to changed circumstances, and quick to change their circumstances. But this advantage also entails a disadvantage: impatience. We are not satisfied with slow, gradual change — we have to change everything immediately, if not sooner. Changes of 3% in State contributions, wages, or other economic variables, which are considered normal in other countries, are considered trifles in Iceland because the need is ten times that. We do not set policies for the long term but prefer to use our weight, will, and industriousness to right all wrongs and injustices. Right now. And then take on the next task. And so on, and so forth.

But this approach is not conducive to maximum success. It amplifies fluctuations. The Government felt this pressure keenly as it prepared its five-year fiscal strategy, which will be introduced tomorrow. No matter where one looks, there is a need for substantial additional funding everywhere. In most instances, strong arguments can be made for the economic benefits of vastly increasing budgetary allocations to the functions concerned. The problem is, however, that even though there are economic benefits to each function individually, the same cannot be said for all of them put together. This is when the bitter economic realities come to the fore.

The fiscal plan for 2018-2022 will lay down clear priorities based on the Government platform. The Government will use the economic scope created by the strong position of the economy and the reduction of debt to place special priority on healthcare. The Government therefore presents five-year strategies for all State functions and links those strategies to funding.

The Government also presents a tax strategy based on reducing taxes on individuals during the electoral term, while increasing taxes on tourism. This is the right time to continue making structural changes to the value-added tax system. There is no longer the same reason as before to grant concessions to the tourism sector by placing it in the lower tax bracket. In addition, it is important from an economic policy perspective to respond to the astronomical increase in tourist visits to Iceland.

The social revolution that has taken place in recent years with the surge in tourist traffic has had a profound effect in many areas. Examples include the economic impact (positive and negative) on other sectors, the impact on the environment, and the impact on the housing market.

The environmental impact is substantial and must be researched more thoroughly. The other day I perused a 30-year-old report from the Committee on the Future, a body established by former Prime Minister Steingrímur Hermannsson. At that time, fewer than 100,000 foreign tourists came to Iceland each year, yet there had been a marked increase over a long period of time. According to that report, most indicators suggested that tourist traffic in the most popular highland destinations had exceeded tolerance limits and severe problems would result if tourist numbers continued to rise by 10% per year, to around 800,000 by 2010. A number of interesting points can be made about tourist visits: for instance, in 2017 and the two years thereafter, the number of people in Iceland, tourists and Icelanders combined, will probably exceed the total number of people here over the first 1100 years of Iceland's settlement.

There is reason to worry about the housing market, as tourism has an enormous impact on it. There is a great need for new housing, both in the capital area and in regional Iceland. It is positive that new homes are being built in regional Iceland after a decades-long hiatus, but the low price of housing in comparison with construction costs is a problem. In the capital area, demand for lots far outstrips supply. The authorities have limited control on the supply side but have made efforts where they can; for instance, by simplifying building regulations so as to facilitate the construction of cheaper, more economical flats and by passing legislation and allocating funding to starter grants for subsidised housing. On the demand side, the authorities have increased housing benefits and laid the foundations for a ten-year tax shelter for young people wishing to use third-pillar pension savings to lower their housing costs. This is important, but there is still much to be done on the supply side. In this area, the City of Reykjavík must tighten its bootstraps. Indeed, it is strange to see how, in the past five years, the population of Kópavogur has grown more than the population of Reykjavík, even though the capital city is three times larger. The City of Reykjavík simply needs to do much better as regards housing affairs.

Honoured guests:

In order to achieve our goals, economic policy and the labour market must pull together. Last year, at the request of the social partners, the Government, the municipalities, the Central Bank, and the Confederation of Icelandic Employers established a Macroeconomic Council whose task is to focus on the interactions between economic policy and the labour market. At the last minute, employee groups chose not to participate. The next meeting of the Council will take place next week.

The labour market is the Achilles heel of Icelandic economic policy at present. There is a distinct lack of consensus and solidarity, as can be heard when federation leaders in both public and private sectors outline their priorities. There is no broad-based agreement to lift the lowest wages or to give special consideration to education. There is simply no consensus to raise the wages of certain worker groups ahead of others. There is no agreement on the reference period for wages that is to be used as a basis for comparison. In these matters, we are far behind our Nordic neighbours.

There are no options available other than to adhere to the framework agreement signed by the social partners. The Government has agreed to participate in that agreement, and it will be used as a blueprint for the upcoming contractual wage negotiations. It is extremely important to preserve the achievements we have made. Wages have risen by 250 b.kr. in two years, and the average total pay of a full-time employee has risen by about 125,000 kr. per month. At the same time, inflation has been at or below 2%. It is not a given that we can maintain this. No monetary policy or fiscal policy is able to maintain stability during a game of leap-frog.

The best opportunity we have at present to improve standards of living is to lower interest rates. But interest rates will hardly decline to any marked degree unless the Central Bank and the financial market are confident that this game of leap-frog regarding the labour market and Government expenditure can be brought under control. There are a number of positive signs, however. The recent upgrades in Iceland's sovereign credit ratings give the State and other market agents the chance to obtain better borrowing terms. Furthermore, market agents' long-term inflation expectations have been at target recently, which is a clear sign of confidence in the monetary policy anchor.

Lowering interest rates is extremely important for households, firms, and the Government. As a rough estimate, households pay 100 b.kr. per year in interest expense, firms pay another 100 b.kr., financial institutions pay more than 200 b.kr., and the Government pays around 80 b.kr. Lowering interest rates by a single percentage point could lower leveraged households' interest expense by 20 b.kr. per year and businesses' and the Government's combined interest expense by 70 b.kr. Reduced Government interest expense means greater scope for spending, and a reduction in businesses' interest expense gives firms greater latitude to lower goods and services prices, provided that competition is sufficient.

Honoured guests:

In closing, I would like to express my deep satisfaction and relief at the liberalisation of the capital controls and to thank all of those involved in the process.

Only two years ago, Iceland's balance of payments problem was considered all but insurmountable because of the enormous stock of foreign-owned assets in Iceland. At mid-year 2015, the problem stemming from the domestic assets of the failed banks' estates was estimated at 900 b.kr. – or 1,200 b.kr., including other foreign-owned assets such as Icelandic bonds and deposits. In comparison, GDP was about 2,000 b.kr. at that time.

The main theme in the authorities' work was to solve Iceland's balance of payments problem so as to enable them to lift the capital controls without undue risk to economic and financial stability. The solution had to guarantee that the króna would not depreciate, that Icelandic firms would retain uneroded access to foreign markets, that Iceland would honour its international obligations, and that fiscal risks would be contained.

Each asset in each of the failed banks' estates was reviewed, and the balance of payments problem associated with each asset was estimated and a countervailing measure found. The estates' assets were dissimilar, and the solutions were accordingly varied. Some of the assets could be transferred directly to the State, while others required different treatment.

This work was very successful, as was the liberalisation process as a whole. There is genuine reason to be glad that the capital controls have been lifted and the reconstruction of our economy has been so successful. I think Iceland's political parties, officials, and other stakeholders can be proud of their achievements in righting the country after the collapse of the banks. The coalition Government of the Independence Party and the Social Democratic Alliance passed the Emergency Act; the Government of the Social Democratic Alliance and the Left Green Party undertook broad-based consolidation measures; the Government of the Progressive Party and the Independence Party solved the balance of payments problem; and the Government of the Independence Party, the Reform Party, and Bright Future brought the whole thing to the conclusion we welcome today.

The capital controls are behind us, and reconstruction is complete. New challenges lie ahead.

It has often been said that it is more difficult to govern Iceland during good times than bad. I think there is a great deal of truth in this. So as we celebrate the milestones we have achieved in lifting the capital controls and the progress we have made, we should remember that according to this theory, that was the easy part. From an economic policy perspective, the difficult times are now at hand.

But no one promised that it would be simple.

Thank you.