

Minister of Finance and Economic Affairs: address at the Annual General Meeting of the Central Bank of Iceland, 17 March 2016

Chairman of the Supervisory Board, Governor, foreign ambassadors, ladies and gentlemen:

Two years have passed since I first attended the Central Bank's annual meeting as Minister of Finance and Economic Affairs. At that time, the first steps had been taken towards lifting the capital controls with the appointment of an expert group that completed its work that same spring and passed the baton to another group, the Task Force for Capital Account Liberalisation.

A year ago, I told guests at the Bank's annual meeting that big decisions would soon be taken which would chart our course towards the removal of the capital controls. The Task Force was then finalising its recommendations for the Steering Committee, with the aim of formulating a plan of action that would enable us to lift the controls without jeopardising Iceland's economic stability.

To the best of our knowledge, no country has ever dealt with a balance of payments problem like that facing Iceland. The country was functioning under the spectre of a huge capital overhang seeking an exit – an overhang estimated by the IMF at 70% of GDP.

It was clear that this unprecedented situation required unprecedented measures.

But what I was unable to share with guests at that meeting was that the authorities' action plan had been launched two days earlier.

At that time, the Task Force and the authorities' foreign advisors had met with representatives of Kaupthing, Glitnir, and LBI's largest creditors and had presented to them, for the first time, plans concerning a stability tax on the estates' assets. For market reasons, we were bound by confidentiality concerning the interactions and the contents of the communications, but this was an absolute watershed in the dealings between creditors and the authorities.

For years, representatives of the failed banks' estates had been calling for a strategy that would map out the settlement of debt so that creditors could export their capital, and now they could see in black and white what the Icelandic authorities' policy was: to lift controls in a manner conducive to political and social harmony. This entailed a requirement that the settlement of the estates must not have adverse repercussions for the people of Iceland.

On 8 June 2015, the capital account liberalisation strategy was introduced and thoroughly explained, and within a month, Parliament passed my bill of legislation providing for a stability tax on the failed banks' estates. At the same time, the authorities introduced the stability conditions that could become the foundation for exemptions concurrent with the conclusion of composition agreements. It is very satisfying to report that, just today, Parliament passed legislation on the receipt of stability contributions.

We see now that it was necessary for the authorities to intervene. If we had not passed new laws and issued an ultimatum, we would probably still be sitting and waiting for the estates to submit ideas for composition agreements.

All of our work and all of our preparation had the aim of creating the conditions needed to settle the estates while maintaining economic stability.

Today, at this annual meeting of the Central Bank, there is good reason to thank everyone who works here for their dedication to the success of the liberalisation strategy. The contribution of the Central Bank and our domestic and foreign experts, not to mention all of the ministerial and other administrative employees who put their shoulder to the wheel, made this success possible.

Appropriate incentives and deadlines ensured that a large portion of the overhang – 30% of GDP – was resolved in about 10 months after the authorities' measures began. When I stood here a year ago, I had only a faint hope that we would be able to solve the problem stemming from all of the failed banks, but we have done it.

The finalisation of the process is now in place with the approved composition agreements. There are no outstanding legal issues.

The aim of our comprehensive liberalisation strategy was – and is – to arrive at a solution that would be neutral vis-à-vis Iceland's balance of payments. It was not a revenue-generating measure.

But the estates' transfer of their domestic assets to the Treasury and various other measures designed to address their ISK problem have already had a strong and lasting impact on Treasury finances.

This is because, even though it will take some time to liquidate these assets and allocate the proceeds towards the reduction of Treasury debt, the assets themselves generate revenues in the meantime – in most instances, revenues somewhat exceeding the interest the State pays on its debt.

In this way, the unprecedented situation that was resolved with unprecedented measures is now having an unprecedented impact on the overall Treasury balance for the future. The transformation of the Treasury's interest balance and the impact on the overall balance are such that I can state with assurance that they will cover the construction of a new national hospital, as will be seen in the five-year fiscal plan to be presented before Parliament for the first time at the end of this month.

For nearly seven years, the capital controls have placed restrictions on residents' ability to diversify risk in their asset portfolios. Domestic saving postpones consumption and investment and therefore automatically contributes to a current account surplus. To put it simply, restricting residents' foreign investments represents a future allocation to the current account balance, as the saving is intended to cover future consumption or investment.

The majority of Iceland's consumer goods and investment goods are imported and will probably continue to be so, owing to the small size of the economy. This is why it is extremely important that we be able to lift capital controls on resident entities as soon as possible, before the pent-up need to invest has become a problem in its own right upon liberalisation, in addition to distorting domestic asset prices.

The next step in the liberalisation centres on offshore krónur. We have made good progress in preparing the next measures, which the Governor will explain further in a few minutes. A successful foreign currency auction, which is our aim, is the key to the next major step in lifting the controls.

It is natural that people should ask how the economy will fare without the capital controls. I want to assure them that we do not intend to run the risk of imbalances like those that developed during the run-up to the banks' collapse.

The capital controls will be replaced by prudential rules, the Financial Stability Council is already at work, and a new regulatory framework for the financial market will make much more stringent requirements of financial market entities than the pre-crisis structure did.

The scenario facing us when we met here in 2014 and I addressed the Central Bank's annual meeting for the first time was very different from that facing us today. I would like to remind you of what I said then: that even though we were still battling various after-effects of the crash, it was nevertheless timely to begin preparing to counteract excessive expansion in order to ensure lasting stability.

And that is the reality facing us now.

In order to get through these difficult times, we have had to use crutches to support ourselves. The most important of them were the Stand-By Arrangement with the IMF, which was financed with the assistance of neighbouring countries, and the capital controls. We have now paid off all of the

emergency loans we received, and we are planning to let go of the other crutch – the capital controls – later this year.

The tasks that lie ahead have changed radically.

The current Government's first fiscal budget was balanced. A budget proposal was submitted with a surplus of half a billion krónur in autumn 2013, and taxing the failed banks' estates made all the difference in putting Treasury finances to rights. The 2014 and 2015 results were better than expected, but that does not change the fact that a heavy debt burden with high interest expense has proven extremely onerous for us. And now we are in the process of deleveraging. Last year we paid off about 10% of our total debt, and this year we intend to pay off more. The Treasury's position is therefore improving rapidly, and in terms of the net position of the economy, it has never been better. Because of these developments and a credible capital account liberalisation strategy, all three major credit rating agencies have upgraded Iceland's sovereign ratings in recent months.

But every silver lining has a cloud attached. GDP growth exceeded forecasts in 2015, measuring more than 4%, and is expected to be similar this year. The slack in output has been absorbed, and tension is developing in the labour market. Wage increases have been larger than is consistent with the inflation target plus productivity growth; therefore, several classic danger signs can be seen on the horizon.

Under these conditions, it is important that fiscal policy provide solid support for monetary policy, so as to ease the tension and prevent instability. In other words, it is important to be prudent in public spending under current conditions. Politicians must bear in mind that, even though elections are head, fiscal policy is an important economic policy instrument that must be wielded with caution. Restraint is particularly important if we are to avoid needing to wield interest rates in a way that would curtail the economic well-being of the general public.

The reconstruction of the Icelandic economy has proceeded more rapidly than expected, but establishing economic well-being is not a temporary campaign. It is not conducive to success to repeatedly outperform our actual capacity and then be forced to rest and regain our strength in between. We must think long-term.

I am optimistic about Iceland's future, and I would go as far as to say that it has never been as bright as it is right now.

Some might say that those are big words, but I can back them up with this:

First of all, Iceland's GDP has never been stronger, both in real terms and per capita. If forecasts are borne out, we are now experiencing the longest growth episode in recent times.

And second, the Icelandic economic machine is running smoothly. Not long ago, I met a man who said, "Bjarni, it was a financial crisis, not an economic collapse, because the pillars of the economy withstood it well."

Of course, this is merely the opinion of one man, but it is constantly coming to light how well the various segments of the economy have withstood these shocks. I refer here to Icelanders' success in creating value from the sea, from energy resources, and from industry. These and many other pillars of our economy have stood strong and provided the foundation for value creation. We are adept at creating value from our resources, but we must never rest on our laurels, and we must constantly look for ways to do even better.

The financial system, which collapsed, has risen again, and today we have strong, well-funded financial institutions.

In this context, it is also important to mention the surging growth of the tourism industry, which it has taken some time to map out and measure. The impact of tourism can be seen, among other things, in

more jobs, more value creation, and more foreign exchange revenues. We have acquired a strong new economic pillar.

The Icelandic economy has never rested on so many solid foundations.

Third, I would like to mention that the debt position of companies and households has improved by leaps and bounds, government finances are in balance, and the debt ratio is falling rapidly.

These three points – a strong GDP growth episode, a robust economy that is more diversified than before, and good progress in reducing the debt of households, businesses, and government – make me optimistic that Icelanders will continue to improve their standard of living.

This sound position stands us in good stead. Let us keep that in mind. But it does no more than that. The future depends on us.

Whether we can stand on our own two feet is in our hands, but I believe we have the tools we need to do it. It requires a collaborative effort, and it demands discipline and a long-term approach.

I have previously spoken of a new framework for government finances. That framework is now a reality, but new legislation is only half the battle.

What we need is a change of attitude throughout the administrative system: we need greater discipline and less reliance on quick fixes. And the legislature itself, the budgetary authority that is Parliament, must focus on the big picture and spend less time on smaller matters.

One of the big questions in terms of the economy is: How successfully will we develop the collaboration and cooperation between governmental authorities and the labour market?

I see clear signs of a desire for improvement, including in the SALEK agreement and the establishment of the Macroeconomic Council, which will convene for the first time in early April. But in the next few months and years, we will see how hard we are willing to work in order to achieve long-term success.

We must set our minds to following up on the positive signs around us. In my view, they are the key to further economic progress.

If we give up half-way through or delay the necessary reforms, we can expect higher inflation and higher interest rates. If that happens, I would like to ask one thing: Don't blame the currency, the Icelandic króna, which is far too often used as a scapegoat for lack of discipline. The Icelandic króna will always be primarily a yardstick for the underlying state of the economy.

These are remarkable times. For those interested in economics and the economy in general, Iceland's experience in suffering a crisis, imposing capital controls, and then lifting them will prove a worthy research topic. Here in Iceland we have set precedents such as the passage of the Emergency Act and our approach to bank deposits, which have already influenced developments in the international regulatory framework. Perhaps other factors, too, can provide guidance to other distressed countries in the future, although it is just as likely that this will not happen, as Iceland's situation is unique in many respects.

A vast number of people have participated in this project, both within the walls of this institution and elsewhere. I would like to take this opportunity to reiterate my thanks to Central Bank staff and to the experts that have worked on the liberalisation strategy, and to thank the Supervisory Board and the Governors for very satisfying collaboration on behalf of Iceland's national interests.