



FJÁRMÁLA- OG EFNAHAGSRÁÐUNEYTIÐ

Annual General Meeting of the Central Bank of Iceland, 2013

Address of the Minister of Finance and Economic Affairs, Ms. Katrín Júlíusdóttir

It gives me special pleasure to address the Annual General Meeting of the Central Bank of Iceland as Minister of Finance and Economic Affairs. The affairs of the Central Bank were transferred last fall to a new Ministry of Finance and Economic Affairs, which was formed in the course of an extensive re-organisation of the Icelandic Government Offices. It is my firm belief that the decision to merge State Treasury affairs and economic affairs under a single ministry placed us in a better position to secure at the same time the goals that we set ourselves in government fiscal strategy and the general management of our economy.

We, the nation, the Icelandic Government and the Central Bank of Iceland, have faced serious challenges since the entire financial system of the country collapsed just over four years ago, but our work is far from over. Ahead lies the task of resolving difficult challenges that affect our national interests.

Since 2010, we have seen a turnaround in our economic affairs in the wake of a banking, economic and foreign currency disaster that shook the foundations of our economy. In the last two years, the economy has grown, despite uncertainty in international markets and serious difficulties among many of our principal trading partners. Our Gross Domestic Product is now at a similar level in real terms as it was in 2006, and we can permit ourselves a degree of moderate optimism that this growth will continue, as investment increases and we achieve a balance in government finances. Interim figures in the State Treasury cash basis for 2012 are now available, and they indicate that the initial balance of the State Treasury was positive by approximately 18 billion krónur on a cash basis, which is 6 billion krónur in excess of the estimate in the Budget Bill for 2013. This is the first time after the banking collapse in the fall of 2008 that we see a primary balance surplus, which represents the achievement of the first target of the government fiscal strategy, which was set in co-operation with the International Monetary Fund. However, the overall balance for 2012 was negative by 41 billion krónur, and there is clearly more work that needs to be done to achieve the second target of the government fiscal strategy of a positive overall balance.

Nevertheless, an important milestone has been reached in our efforts to stop the accumulation of State debt and begin to reduce our debts in the coming years. Over the last four years, the State Treasury has had to undertake increased obligations and burdens which can largely be traced to the consequences of the banking crisis in the fall of 2008. Fiscal measures taken by the government have therefore needed both to counterbalance increased expenditures and reduce the fiscal deficit. In light of the trends in government finances in a number of western countries, it is a notable achievement that the total improvement in the primary balance on a cash basis in 2009 to 2012 amounted to just short of 120 billion krónur, or 7.7% of GDP.

Next year, the forecast is for a positive overall balance, and after that point is reached a primary fiscal objective will be to start gradually and steadily reducing the fiscal debt. This can only be done if the Treasury returns a hefty surplus over a number of years, or the sales of State assets are used to repay debts. To illustrate the enormous size and time frame of this task, even if the State Treasury showed a surplus of 50 billion Icelandic krónur and this were used to pay off debts, it would still take ten years to reduce the debt by a third. It will therefore be necessary to continue to maintain firm control and balance in fiscal affairs and stand in the way of unreasonable increases in expenditures. Accordingly, it is now time to elaborate in further detail our long-term fiscal objectives of reducing the total government debt to about 60% and prepare an analysis of how and when we can achieve these objectives.

In recent months the discussion of ways to remove the existing restrictions on the movement of capital has gained added force. It is clear that we are approaching the time for important decisions on ways to resolve the balance of payment problem that the country has been facing and to pave the way for the removal of capital controls on individuals and businesses. The programme for removal of the controls which was introduced in the spring of 2011 was mostly directed at the offshore krónur prolems, as it stood at the time, and it is certainly positive that this problem has been mitigated somewhat through the Central Bank's auctions and Investment Programme. However, it has become clearer that the problem is larger than that and relates to the winding up of the failed banks and the outflow of currency that could ensue.

It is clear that the government will need to act in a co-ordinated manner and work on a comprehensive solution to the problem. As Minister of Finance and Economic Affairs I took steps to revive the Steering Committee on the Lifting of Capital Control, where the members, in addition to myself, are the Minister of Industries and Innovation, the Governor of the Central Bank of Iceland and the Director of the Financial Supervisory Authority. The steering committee is a venue for consultation and decision making relating to the programme for the removal of controls, and the Committee is currently working on reviewing and updating the plans for the removal of controls based on various scenarios of the resolution of the commercial banks' estates. The scope of the task has become clearer in recent months, as have the possible solutions.

This task, of taking measured and effective steps to remove the capital controls touches all of us and our future. I have made attempts to achieve as wide a political consensus as possible in the matter through cross-partisan consultation. No one disputes any longer the importance of gaining full control of the flow of capital from the banks' bankruptcy estates to creditors by placing their foreign assets under the capital control in March last year. We also succeeded in achieving a complete consensus on the need to remove the specific date of removal of the controls and focus instead on achieving specific results. We also have a more formal decision-making process regarding rules on payments out of the failed banks and consultation and information in the granting of large exemptions. Legislation on this change was passed in the Althing, and a similarly broad consensus is now being achieved on a loosening of the controls for households and, as well as improved tools for the Central Bank to implement the controls.

The Government and the Central Bank have walked fully in step in their approach of going as far as our law and international obligations will permit us in our defence of Icelandic interests. The message that there is a complete consensus on this position, regardless of party lines or election results, is important.

There are indications that the creditors of the failed banks' estates are now assessing the value of their claims in a more realistic manner. The interplay between a realistic valuation of claims and the exchange rate could be the key to stave off the avalanche of fickle krónur that will otherwise ensue following the winding-up of the estates. This situation confirms what an important step it was to negotiate with the creditors on their taking ownership of the banks instead of the State taking them all over, in which case the creditors would hold a bond on the entire Icelandic banking system. Under those conditions, the risk of the real value of the claims would be entirely ours, while the pressure on the exchange rate of the króna resulting from payments to creditors would be steady and independent of the real value of the claims.

The estates of the failed banks that are being wound up are subject to civil law; they are private entities holding claims against the estates. The State, on the other hand, only owns a small share in the new banks in which the estates hold shares. This situation is important in light of the discussion of the importance of the State not taking excessive risks in connection with the on-going winding-up proceedings of the old banks. This does not change the fact that the State may have both a direct and indirect interest in a favourable resolution of this matter. For households and businesses the principal interest lies in improved stability of the exchange rate and price levels. In the best case scenario there could be room to reduce the debts of the Treasury, thereby releasing the capital currently being used to pay interest for use in other and more urgent tasks.

However, as I mentioned earlier any discussion on how to use these funds is untimely. This is not cash in hand, and it is irresponsible to refer to it as such. Let us approach the matter realistically, with Iceland's fullest interests in mind. That will bring us results.

Among the most urgent tasks ahead in Icelandic politics is deciding on the direction to take in monetary policy. What should follow once the capital controls are removed. The detailed report of the Central Bank of Iceland on the options available in currency matters and a review of the macro-prudential tools that need to be available in the coming years are an important contribution to the discussion.

Unfortunately, responsible discussion by others of a future vision in monetary affairs is something of a rarity. Every once in a while ideas are tossed up on unilaterally adopting this or that currency without any mention of what sort of monetary system we intend to build on that platform or how we would go about ensuring stability.

In my opinion, much of what we regard as temporary discomfort following the economic collapse will become a permanent state of affairs if we make the decision that the króna should remain our currency for the future and that the króna will endure without the immense fluctuations that are so unfortunately familiar to us. Others appear to be quite satisfied with roller-coaster fiscal policy and rely on the much lauded flexibility of the króna to make sharp cuts in purchasing power in Iceland and render us competitive in the shelter of low domestic costs. I fear the impact of this route on our possibility of developing a more diverse economy, in particular on the sector that is called the "International Sector" in the McKinsey Report on a Growth Path for Iceland. The International Sector consists of the export businesses, who do well in international competition without reliance on the utilisation of local Icelandic resources. These are companies that exploit that inexhaustible resource, ingenuity. It is in this sector that many of the companies operate that we Icelanders look upon with the greatest pride, and some of them have in fact sprouted from our established fundamental industries, the fisheries sector in particular.

It should come as no surprise to anyone that I advocate the utmost caution in fiscal matters, that we should strive for a stable exchange rate and stable price levels, while at the same time reducing our debt so that we can at the earliest possible opportunity meet the conditions to join ERM II and eventually adopt the euro as our currency.

In the discussions of monetary options I am sometimes reminded of the story of the tourist who stopped his rented car in Dublin to ask an elderly local for directions to Cork. The old Irishman scratched his head, and then said: "If I were going to Cork I wouldn't start from here". That was the only answer the tourist got.

To my mind it is important to know what our destination is so that we can organise our trip, choose an appropriate means of transportation and prepare accordingly. When I look at the conditions we need to meet, I see the results of a sensible fiscal policy. This is the route to the stability that our households and businesses need.

The on-going discussion of index-linking sometimes tends to overlook the fact that the real problem is inflation. Inflation, which to a large extent results from the uncertain value of our currency, causes difficulties for households and keeps interest rates high, and impairs the competitiveness of our industries.

In the coming years we need to earn more than we spend, and to do so we need investment in our industries, which is another reason to adopt the euro. Countries that have adopted the euro have subsequently seen increases in direct foreign investment, in particular from other eurozone countries.

What makes it even more important for us to proceed with foresight and caution is that the prospects in the world economy are still dangerous. The difficulties in the eurozone are not behind us, even though the prospects of stability have improved; however, political unrest in debt-laden countries can have unforeseeable consequences. In the United States, the fiscal cliff has created uncertainty, which to some extent has abated. Economic growth in Iceland's main trading regions has slowed down in recent months, and has in some places been negative, which is cause for concern. We are not an island in the economic sense. On the contrary, all the industries that account for our foreign currency revenues, and thereby our entire economy, depend on an improved situation. It is therefore cause for moderate optimism that international analysts believe that, in spite of everything, financial stability in general has improved, and that economic growth in the developed countries will be revived in the second half of this year and next year.

Ladies and Gentlemen

When I look back on the last four years, I am proud of the results that we have achieved. But I am also realistic, and I understand the difficult challenges that lie ahead.

Unfortunately, the time of harvest has not yet arrived. It is important for us to stick to the fiscal strategy of starting to reduce the State debt next year. To do so, we need to show discipline and keep a tight rein on government spending. Figures on the economic growth of last year were disappointing, both here in Iceland and in most of our neighbouring countries. The economic prospects in the world are uncertain, and even though we are experiencing growth above the average of the developed economies of the world, this is not cause for exultation.

In the weeks leading up to the coming elections, it is urgent for politicians to show responsibility and refrain from irresponsible promises that could bring on new catastrophes.

We have reached more or less firm ground, we see the opportunity to resolve our biggest problems in the near future and prepare the ground for increased stability and prosperity. This is where our most important interests lie in the coming years, both for our businesses and our households. It is my hope that we will achieve a mutual understanding and consensus on the task ahead.