

THE SPOKEN WORD APPLIES

**Address
by Prime Minister Geir H. Haarde
to the Annual Meeting of
the Central Bank of Iceland,
March 28th 2008**

Ladies and gentlemen.

Financial authorities around the world are currently dealing with one of the most difficult tasks facing them for many years: How to avoid a serious financial depression that would have grave consequences for the world economy. Ever since around the middle of last year, when two so-called hedge funds in the United States encountered difficulties due to their investment in sub-prime debt vehicles, the world financial markets have drifted into an increasingly serious crisis. Investors have sold their bank shares in many countries and their share prices have declined sharply. Distrust between banks has been sown and they prove reluctant to lend to each other, preferring to increase their liquidity rather than lend money to customers and other banks. When the lubricating oil of the financial engine dries up, the engine eventually stops. The central banks of the main industrial countries have therefore had to resort to measures to stave off a liquidity crisis by injecting funds into the banking system. The Central Bank of Iceland has done the same thing.

It is therefore no wonder that the Economist magazine in its latest issue devoted ten pages to the problems of Wall Street and the international financial system.

The state of the Icelandic economy

All signs indicate that the substantial expansion in the Icelandic economy is drawing to a close. The international financial difficulties I discussed earlier have dimmed prospects in the world economy. The external conditions of our economy are therefore less favourable than before. In addition, the power project investment in the eastern part of the country are being completed, which will have a decisive impact on the course of our economy over the next several years and slow down our rate of growth.

By current forecasts, the economy is set for a slowdown towards an equilibrium after several years of rapid expansion that has strengthened our economic foundations and that will in my opinion render great wealth to our country for years to come. Aluminium exports are set to grow rapidly over the next several years when new plants reach full capacity. In addition, further power-intensive production or services are expected to be developed over the next several years. On the other hand, the combination of domestic developments described earlier and the unforeseen course of international financial markets that are beyond our powers complicates these future prospects.

The Government had naturally prepared for the course of events foreseen at the time when the fiscal budget was drafted along with the counter-measures implemented in connection with the cut in the cod catch. Furthermore, the Government decided on special measures and tax cuts in connection with the recently concluded wage

agreements. These measures are currently being prepared and their timing will be set so as not to counter the efforts of the Central Bank to reach its inflation targets.

It has been long foreseen that the exchange rate of the króna would decline as the economy slowed down, especially because the exchange rate has generally been seen as too high for some time in light of economic conditions. The most recent decline however is not in accordance with expectations and has other causes. Although it will inevitably lead to more inflation, I expect that the exchange rate will find a new equilibrium when international financial markets calm down and most of the current uncertainty has passed. The measures of the Central Bank last Tuesday will clearly help the currency find a new equilibrium.

The negative discussion of the Icelandic economy that has recently appeared in several foreign newspapers has caught us by surprise. When we view the facts of the Icelandic economy, all economic figures and forecasts broadly agree that the prospects for the economy are good, that the economy is healthy and the banks sound. This has been well confirmed by foreign experts, such as Mr. Frederic Mishkin, now a member of the Board of Governors of the Federal Reserve, and by Mr. Richard Portes, a well-known economic expert.

Monetary policy

In the present Central Bank Act of 2001, the Bank is entrusted with the task of maintaining stable prices, i.e. keeping inflation in check. In a joint statement of the Government and the Bank, the inflation target is defined as an inflation rate of 2.5 per cent a year, as measured by the consumer price index, with an upper and lower limit. In order to attain its inflation targets, the Bank primarily uses interest rates in its transactions with the financial sector. The Central Bank interest rate creates a foundation for other interest rates in the country. The current policy rate stands at 15 per cent and has increased from just over 5 per cent in the spring of 2004 when the current phase of increases commenced. The Central Bank is independent as is common amongst central banks in western countries. This means that the Government, in this instance the Prime Minister who deals with the Bank's affairs, does not interfere in the implementation of monetary policy or in individual interest rate decisions.

It is no secret to anyone that the debate on the Central Bank's monetary policy, along with its interest rate decisions, has become more intense and critical as the policy rate has increased and the high-interest period has dragged on. The reason for this is twofold. On one hand, the high rates of interest are beginning to bear results in the sense the interest costs of households and businesses have begun to bite enough for them to change their behaviour and cut their spending. There is not much to be said against this, since this is exactly how the Bank's policy rate is supposed to work.

Another criticism is that, due to special circumstances in this country, the impact of monetary policy is little or negligible. If this criticism is based on sound arguments, it must be taken seriously, since it is important that one of the two main instruments of economic policy is working as it should. In this connection, it is also argued that premises of economic policy have been fundamentally changed due to increased capital movements and globalisation and thus reduced the powers of monetary policy from the days of our old, closed economy.

These issues are being debated in all developed countries by critics and scholars. The definition and implementation of monetary policy has never been chiseled in stone but rather evolved through experience, research and cumulative knowledge. This applies both to the legal framework and policy implementation. A number of discussants have posed questions along these lines. In the latest survey of the OECD on the Icelandic economy it is observed that perhaps it would be desirable to review the definition of the inflation target by amending the composition of the reference index, in part by reducing the weight of housing prices. Others have raised the question whether the Central Bank has all the tools in its possession necessary to do its job.

The time will soon come when these issues must be critically examined in cooperation with the Central Bank since it will be necessary to respond to questions that have been raised, assess experience from the implementation of the 2001 Central Bank Act and whether the present fundamentals are the most suitable for the future. We must call upon our most competent scholars, both foreign and here at home, as has been done elsewhere. This should not be seen as a criticism of the Bank's monetary policy but rather as an effort to better enable it to carry out its duties. At present, it is of prime importance to help the Icelandic financial system overcome the disquiet that it has experienced because of international financial circumstances.

The banking system

We Icelanders have long been a nation of fishermen. Although the fishing industry is very diversified and can not all be lumped into one, it is nevertheless a fact that economic fluctuations used to originate in the fishing industry.

When we became members of the European Economic Area, we gradually moved into a more modern and liberal direction. Many of the impediments were removed that had hindered the entrepreneurial initiative of businesses and individuals. A determined privatisation transferred decision-making in numerous enterprises from politicians to private individuals. At the same time, tax cuts and changes in the system of taxation unleashed new economic powers. All these things have created immeasurable progress for our nation and laid the foundation for a vigorous growth of numerous Icelandic enterprises as well as for a more profound structural changes in the economy than we have seen in decades.

The development of financial services is the most outstanding example of a sector that has flourished in this environment. The three large commercial banks have changed from being purely local banks that almost only offered traditional deposit, lending and transfer services into international banks offering diversified services in many countries. And their growth has been rapid. The combined assets of the three large banks are equivalent to the eightfold gross domestic product of Iceland. The banking system has created a large number of new jobs. The pay in the banking sector is on average higher than in most other sectors, and the banks have become important customers of specialised experts and various service firms. The share of financial services in GDP has increased from 6 per cent to 10 per cent in less than a decade and by this measure surpassed both fisheries and manufacturing.

The substantial economic growth in recent years along with a successful privatisation has created a healthy Treasury balance that has in part been used to repay debt. The net debt of the Treasury is now quite small or almost nonexistent, a fact that few western

nations can boast of. This means that the Treasury is in a strong position and can therefore borrow sizeable amounts if necessary. There is no doubt that the Treasury and the Central Bank could provide assistance if a serious situation were to emerge in the banking system. I have repeatedly been asked about this by foreign parties in recent weeks and I have always responded that the Icelandic authorities would in such circumstances not hesitate to resort to the same measures as responsible authorities in other countries. I am restating this now.

The Treasury borrowed abroad a year ago to strengthen the foreign exchange reserves of the Central Bank. Previously, I have said that the right thing to do is to continue on this course and I reiterate that now. It should also be explored whether the Central Bank can enter into cooperation with central banks in other countries where the Icelandic banks have a considerable presence. These issues are being looked into by the Central Bank. I think it is also important that the Bank has twice this year eased its rules of access to loans for financial firms, the latter measure as recently as earlier this week. By this, the Bank is emphasising its willingness to resort to measures as necessary during the period of disquiet in international financial markets.

Financial firms around the world are currently engaged in a period of difficulty. Icelandic firms are no exception but in addition, the three large banks have been faced with the problem that their so-called CDS spread has sharply increased. This seems most illogical to me, since their fundamentals regarding operations and assets give no reason for this. The absurdity of the CDS spread becomes apparent in the case of the Icelandic Treasury that is almost debt-free but is nevertheless rated on par with heavily indebted countries.

Conclusion

The financial sector has become one of the most important sectors in the country. I see it as very important that it will be in a position to continue its growth. The public authorities can play an important role here by creating first-class growth conditions for this sector. One element is the planned cut in corporate income taxes from 18% to 15%.

The Icelandic banking system and the Icelandic economy are both on strong foundations in spite of the current adversity. The systematic dismantlement of various economic restrictions in the past decade and a half, the series of privatisations, determined tax cuts and the globalisation of the economy have already yielded enormous dividends and paved the way for a new period of progress in coming years. We will not hesitate to continue on this path, once we have emerged from the temporary difficulties we now face.

In closing, I wish to thank the Board of Governors of the Central Bank, the Supervisory Board and the Central Bank staff for its work and cooperation in the past year.