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Ladies and gentleman,

Iceland's journey from exuberance to despair – and at least half-way back again – has been difficult but informative. We can now look back at what has been achieved with some degree of satisfaction. More importantly, by looking back we can draw some lessons that should help us to address the problems we see on the horizon looking forward. After five years of recovery, the Icelandic economy has more than recovered the output it lost in the aftermath of the financial disaster of 2008 and is expected to grow this year at rate close to 4%, a pace similar to last year's. More importantly, the current level of output appears sustainable, unlike the pre-crisis output, which could only be sustained as long as foreign funds to finance a double-digit current account deficit were forthcoming, in defiance of rapidly rising foreign debt. Inflation has been brought down from 18% in the aftermath of the banking crash to a rate below the 2.5% inflation target. An oversized cross-border banking sector has been replaced by a smaller, domestically oriented, simpler, better capitalised, and more tightly regulated domestic banks. Sizeable profits, albeit in large part attributable to irregular items, have improved the resilience of the banking system, and the banks' liquidity position is relatively strong. Fiscal policy has been placed on a sound footing, both as a result of the measures taken to tighten policy during the Stand-by Arrangement with the IMF and as a result of the economic recovery. Public debt ratios are falling, and the outlook is for a substantial decline in public sector debt ratios in coming years.

Private sector debt ratios have also declined, helped by debt relief, economic recovery, and insolvency proceedings. The banks' NPL ratios have come down from some of the highest in Europe to a comparatively low level. Important progress was made last year in winding up the failed banks. They have been granted exemptions from capital controls enabling them to go into composition and pay distributions to creditors after meeting stability conditions that eliminate the huge balance of payment risk that would otherwise have resulted from their resolution. What emerges at the end of the de-leveraging and winding-up process is the most favourable international investment position (IIP) Iceland has seen since the mid-1960s. If the current account remains in surplus for a few more years, as forecast, the IIP will become positive, compared to a negative position equivalent to 106% of GDP at the end of 2007, and much worse in the aftermath of the crisis.

Difficult challenges lie ahead, however. The recent economic gains are not only the result of good policies, but also good fortune. Three types of positive shocks to the economy can be identified: First, the favourable effects of winding up the old banks on net external debt, on top of deleveraging since the crisis broke. Second, terms of trade have turned strongly in Iceland's favour in the last two years, from a forty-year low in 2013. Third, exports have been boosted by an unprecedented boom in tourism, which last year surpassed fisheries and aluminium as Iceland's largest export sector. The boom continues. In Q4/2015, tourism-generated revenues grew by 40% year-on year. While this is good news, the extraordinarily rapid increase in tourism raises questions of sustainability. The infrastructure is under strain, and it is uncertain to what extent growth in tourism is sensitive to eventual rise in fuel prices and hence airfares, the rising real exchange rate, the vicissitudes of fashion or other external factors. At some point, the current shortage of hotels rooms is likely to turn into a glut.

More worryingly, the labour market has apparently become overheated. Unit labour costs rose at a rate of close to 10% in 2015 and will do so again this year, while labour productivity growth is weak. Although partly offset by the previously mentioned improvement in terms of trade, this will inevitably lead to rising inflationary pressures. This will call for tight monetary policy is spite of low current inflation, which reflects an appreciating currency and falling import prices. At the current exchange rate, the recent wage settlements are also bound to raise Iceland's real effective exchange rate significantly above historical norms (albeit not as high as in 2005 and 2007), undermining competitiveness and making the economy more vulnerable to a possible terms of trade reversal and other external shocks.

For European policy makers, solving problems of an economy that is becoming too strong may sound like an enviable position. However, in view of Iceland's history of boom-bust cycles, we should not take much comfort from the problems policy makers in other countries are facing. On the contrary, conducting monetary policy in a very small, open economy out of sync with the rest of the developed world is a serious challenge, as we learned during the period leading up to the financial crisis of 2008. With short-term interest differentials with abroad close to 6 percentage points, a strong fiscal position, rapidly falling public and private sector debt ratios, a current account surplus, and external debt falling to historically low level, Iceland has become an attractive – albeit very small – target for a potentially huge pool of global investors desperately searching for returns. In spite of the uncertainty still surrounding the final steps towards lifting the capital controls, foreign investors have bought Treasury bonds worth 70 billion krónur (equivalent to 3.2% of GDP) over the past twelve months. This is still manageable, but it adds to a steady stream of foreign currency entering the economy via the current account, when exporters are still subject to repatriation requirements.

Last year the Central Bank bought foreign currency equivalent to 13% of Iceland's GDP in the interbank market, restraining the appreciation of the króna over the course of the year to 7%. In the first quarter of this year, foreign currency purchases have surged even more in comparison with the same period last year. Accumulating foreign reserves at this pace would be unsustainable were it not for the substantial amount of blocked non-residential investment waiting to be released and the potentially pent-up demand for foreign investment by residents. An auction to release blocked non-resident ISK claims is pending. Once the resulting adjustments have taken place and, subsequently, as most restrictions on the capital account have been lifted, foreign demand for domestic securities may rise further. Hence, the Central Bank has been looking at various options for dealing with potentially destabilising capital inflows by applying capital flow management tools. But capital flow management and macroprudential policies should be seen as a complement to responding to excessive capital inflows by tightening fiscal policy, not a substitute. Furthermore, whether these measures will fit with EEA rules on free movement of capital remains to be seen.

Apart from dealing with volatile capital flows head-on, we also need to strengthen the resilience of the economy in general and the financial sector in particular in the event of destabilising cross-border capital flows. Much has already been achieved or is likely to be implemented in the near future:

- The domestic commercial banks have become more resilient. The three largest banks' T1 capital ratios are over 28%. In line with CRD-IV, additional capital buffers amounting to 8.5% have recently been imposed on major banks, increasing their resilience against shocks to the economy. This includes a 1% countercyclical capital buffer effective at the beginning of 2017. Further countercyclical capital buffers will most likely be imposed as the economy picks up steam.
- The Icelandic banks are no longer engaged in substantial cross-border activity. Moreover, they face more restrictive NSFR limits on their foreign currency liabilities than their foreign peers. Further work on requirements for their foreign exchange balance is in progress.

- According to a bill to be submitted to Parliament, the Central Bank will be given powers to regulate the foreign currency exposure of parties with inadequate foreign exchange hedging. Rising foreign exchange liabilities of companies and households with inadequate foreign currency revenue or assets fed the boom and subsequently triggered enormous losses to the financial sector when the króna plunged in 2008, deepening the recession substantially.
- According to a draft bill before Parliament, the Icelandic financial supervisor (FME) will, following recommendation from the Financial Stability Council, be equipped with powers to impose limits on loan-to-value ratios and, hopefully, on debt service-to-income ratios as well.
- A new governance structure is in place to apply the macroprudential tools mentioned above: the Systemic Risk Committee and the Financial Stability Council.

Confidence may take decades to build up but can be lost almost instantaneously. Ever since the crisis broke, we have worked hard to regain the confidence lost as a result of it. The fact that capital controls are still in place underlines that this work is not completed, but we have come a long way. We have broken the vicious cycle between banks and the sovereign (which affected some Eurozone countries as well as Iceland), mainly with a combination of orthodox fiscal and monetary tightening, in contrast to what some seem to believe, but also with essential help from some unorthodox financial sector ring-fencing measures, including the so-called emergency legislation and temporary capital controls. The latter was a necessary evil in the absence of a proper cross-border co-insurance mechanism. These measures brought about significant short-term social and economic benefits, but at unknown long-term cost.

For a very small, open economy, the benefits in terms of efficiency and cross-border risk-sharing brought about by free trade and free capital movements are essential. However, these also carry substantial risk, as we have learned. We need to find the right balance between risk and efficiency, either through participation in a proper cross-border co-insurance mechanism or by resorting to self-insurance through appropriate ring-fencing measures that preserve as many of the benefits of free capital movements as possible but without excessive risk-taking. We have learned important lessons from the recent crisis, but there is no panacea for all future problems of running independent monetary policy in a very small, open economy with free capital movements. The idea that such an economy can be isolated from the global financial cycle is a dangerous illusion, a fact made clear by a recent study showing strong spillover effects to Iceland from the global financial cycle over a period of more than a century. But if monetary policy is adequately supported by fiscal, macroprudential, and capital flow management policies, it should be possible to alleviate some of the excesses that have characterised the Icelandic financial cycle, which, after all, is only a variation on a global theme.

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