



CENTRAL BANK OF ICELAND

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Statement by the Hon. Davíð Oddsson, Governor of the Fund for Iceland, on behalf of the Nordic-Baltic Constituency at the Joint Annual Discussion

Final

Introduction

1. I am honoured to address the 2008 Joint Annual Meetings on behalf of Estonia, Denmark, Finland, Latvia, Lithuania, Norway, Sweden and Iceland. Let me begin by thanking the City of Washington for its usual warm welcome.

The world economy and financial markets are put to the test

2. The outlook for the world economy is more challenging than it has been for some time. After years of robust growth and low inflation, the tide has turned. Growth is slowing, demand contracting and inflation rising. In addition, financial sector problems may further hamper growth in the short term.
3. The policy response to the current economic environment is challenging, but the priority should be clear. Policy makers should take the threat of inflation very seriously. Experience has shown that inflation expectations are difficult to tame once they become entrenched. We must stave off this threat: the social cost of inflation is too great for us to do otherwise. At this point, there are signs that inflation expectations are becoming unhinged and we have yet to see the potential second-round effects from the surge in commodities prices. Therefore, policy makers worldwide must monitor inflationary pressures closely and respond accordingly thereby supporting sustainable growth and employment.
4. One of the key foundations for long-term sustainable growth is a strong financial system. Conditions in international capital markets have changed significantly since the last Annual Meetings. The current environment has proven difficult for many financial institutions, as the credit and liquidity squeeze continues to bite and assets are being written off. It is quite evident that risk was not priced appropriately over the past few years. The repercussions are bound to stay with us for some time.
5. Cycles are a familiar characteristic of human nature – and indeed, of nature itself. Yet, there is always the conviction that “this time it will be different”, and then, when the tables turn, there comes the realisation that finding a solution to the problems of the last cycle, so as to prevent the next one, is never easy. However, let us hope that the latest experience will result in more forward looking policies and effective regulation of the financial sector to control risk and to reinstall confidence. We must also seek to ensure that changes in business practices do not reduce transparency. Moreover, efforts must be made

to breathe life into interbank markets and thus to reduce what has become come excessive reliance on central bank financing.

I would like to highlight two issues of importance in the current situation: namely, the lack of transparency in certain sections of the financial markets and the emergency powers of authorities.

6. The global economy has seen a significant rise in over-the-counter (OTC) transactions. The main purpose of OTC instruments has been laudable; that is, to hedge risk and facilitate trade and increase depth in financial markets. The OTC markets are useful as such, and, during normal times when liquidity was ample, they were quite effective. However, the OTC markets are opaque, and because of the lack of transparency of credit derivatives and the false sense of security they engender, including that provided by rating agencies, they have become a risk in themselves. Improvements should be made in market making practices in the OTC markets. The markets need to become more transparent, information sharing should be increased, and players in the markets must become more aware of the risks involved. Policy makers need to have a better oversight of these markets in order to have the appropriate policy tools to deal with adverse developments.
7. Many financial institutions are experiencing difficulties. Some have gone under, others been rescued. The liquidity facilities of central banks and contingency plans of authorities are being put to the test. There is good reason why authorities have processes in place to address situations that can jeopardise the stability of the financial system – and hence the economic welfare of nations. Because of assumed public support and contingency mechanisms, some market participants have not appropriately priced risk. Thus there is moral hazard which requires moderation. Policy makers should revisit the ideology behind emergency powers, as it was originally based on more contained risks, within balance sheets, and a clearer separation between commercial and investment banking.
8. As many countries are feeling the effects of slowing economic growth and distressed financial markets, it is of great importance that authorities demonstrate strength and that central banks, financial supervisory authorities, and governments cooperate effectively in these challenging times. Words must be matched with action. Strong collaboration and candid dialogue with financial institutions will be vital. The International Monetary Fund can play an important role in the current environment, especially in its role as a confidential advisor in its financial surveillance capacity.

Low-income countries have shown strength, but more challenging times lie ahead

9. In recent years, there have been positive developments in many low-income countries. Economic growth has been robust, debt ratios have fallen, and trade has increased. However, there are signs that more difficult times may lie ahead, as the increase in food and fuel prices could have distressing effects on import-dependent countries. The surge in prices could undermine the progress made in recent years to combat poverty.

10. My constituency believes that the Fund should continue to be engaged in low-income countries; however, the focus needs clarification to be more effective. The future engagement with low-income countries must remain within the Fund's mandate. The main emphasis should be on macroeconomic issues and temporary concessional lending. The Fund has extensive experience in this field. Its emphasis should be on areas where it has a comparative advantage. Areas beyond its expertise should be left to others.

Reforms of the Fund will pay off

11. The Fund has been undergoing a significant transformation over the past few years. We believe it has been successful in adjusting to new circumstances.
12. The Nordic-Baltic Constituency believes that, for the Fund to be effective in the global economy, adequate and fair representation of all members must be ensured. We are especially pleased with the tripling of basic votes, as this action represents an effective way to increase the voice of low-income countries and small states. We place special emphasis on voice in this context and broad-based representation of the Fund's members in the Executive Board is important. Another important matter – and one that we think would further enhance the legitimacy of the Fund as a global institution – is a reform of the criteria and procedure for the selection of the Fund's senior management.
13. Significant work has been done on Fund finances over the past year. As credit intermediation is no longer the main source of Fund revenues, other ways have been explored on both the revenue and expenditure sides. The Nordic-Baltic Constituency welcomes the steps that have already been taken. Furthermore, the constituency believes that its income-generating potential should be explored further. It is of great importance that the Fund be successful in its reforms. The Fund should aim at becoming a role model to others for such transformation. We welcome the envisaged gold sale of the Fund and hope that parliaments in member countries will facilitate it.

Conclusion

14. In closing, the end of the Doha round was a disappointment for the global economy. We should reopen the discussions and seek to bring them to a prompt and successful conclusion.
15. As I have underlined, these are challenging times, but while the economic slowdown is underway, policy makers have been responding, and there will be self-correcting features in the global system that will contribute to easing the adjustment that lies ahead. In facing these challenges it will be imperative that the international community works in partnership.