Arnór Sighvatsson: Iceland's future monetary and exchange rate regime

Speech by Mr Arnór Sighvatsson, Deputy Governor of the Central Bank of Iceland, at a meeting of the Icelandic Federation of Labour, Reykjavík, 10 January 2012.

* * *

Ladies and gentlemen:

In the wake of severe financial and monetary instability, it is appropriate for the Icelandic authorities to conduct a comprehensive review of Iceland's exchange rate and monetary policy regime. The re-assessment must be based on an accurate diagnosis. The authorities should not only review the experience of recent years, but also grapple with the fundamental questions of why Iceland's monetary policy track record has been so dismal, over nearly a century, that the Icelandic króna has depreciated by 99.95% against the Danish krone since the two currencies were uncoupled in 1920.

Monetary policy generally faces two conflicting roles of the currency exchange rate: to be an anchor of monetary policy, on the one hand, and a tool for adjustment, on the other. During the Icelandic króna's lifetime as an independent currency, exchange rate policy has moved along the axis between fixing and floating, but without managing to stop the virtually uninterrupted erosion of the króna's purchasing power except for short periods of time.

There could be four potential types of explanations for Iceland's poor performance in the field of monetary policy, and corresponding types of measures for improving the performance:

1. First of all, the source of the problem might be the *implementation of monetary policy or its framework*. The framework has been strengthened in various ways since the turn of the century; for example, by enhancing the Central Bank's independence, adopting an inflation target, and appointing a Monetary Policy Committee. Even though performance over most of the period under scrutiny has fallen short of set objectives and has been poor in comparison with other countries, inflation has declined more rapidly in the wake of the recent financial and balance of payments crisis than after the inflation episodes of the 20th century, when it often proved extremely persistent, partly because interest rates were held abnormally low. The monetary framework might be strengthened further, however, by providing the Central Bank with supplemental tools, in addition to its interest rates, that could boost the efficiency of monetary policy.[1] Applying macroprudential tools effectively and strengthening the regulatory framework governing the financial activities that have caused the recent instability could possibly improve performance.

2. Second, economic policy, more generally, might explain the poor track record. Fiscal dominance and an employment policy that placed too heavy a burden on monetary policy probably contributed significantly to high inflation in past decades. Enhanced Central Bank independence and the prohibition on direct Treasury borrowing from the Bank have reduced fiscal dominance. This has been beneficial, as is indicated by the fact that the inflation episodes in the first decade of the 21st century have been shorter-lived than those in the latter half of the 20th. Even in this century, however, there has been a conflict between fiscal and monetary policy – that is, fiscal policy has not supported monetary policy sufficiently, as it would if fiscal policy were anchored on a nominal expenditure plan several years ahead. This has proven difficult to carry out.[2] It is hard to apply such a rule if exchange rate volatility causes

---

[1] In recent years, the Central Bank has presented proposals for such reforms in two reports to the authorities.

[2] An attempt to adopt such a rule was made in connection with the Government-IMF economic programme, but it appears to have been abandoned when put to the test.

instability in Treasury expenditures (and revenues). Furthermore, Iceland lacks a proper institutional framework – either a domestic agency (such as an independent financial council) or a foreign body – to support such policy and exercise a measure of surveillance and discipline over fiscal authorities.

3. In the third place, the source of poor performance may lie in Iceland's economic structure, e.g. its volatile export sectors and relatively undiversified economy. The *structure of the Icelandic economy* is not that different from other developed countries, however. Public and private services constitute the largest sectors of the economy. Although commodity-based exports could be a source of instability, Iceland is far from being the only developed country in such a position. Other developed commodity exporters – Norway, New Zealand, and Australia – have been much more successful at achieving price stability than Iceland has. Reform of the fisheries management system and technological developments in the fishing sector, together with increased diversification, have made the economy less vulnerable to the vicissitudes of nature.[3] I doubt the structure of the economy is a major factor here, but it could be possible to enhance diversity by, for example, facilitating foreign investment in new sectors.

4. Given that performance has been poor throughout a very long period over which various exchange rate regimes have been in place, it is natural to consider the currency itself and the small size of the currency area. Iceland is unique as regards both the size of its currency area and the volatility of private consumption, even when its small size is taken into account. It appears obvious that fluctuation in private consumption is driven primarily by exchange rate volatility, as Chart 1 shows. It is difficult to reduce fluctuations in private consumption unless exchange rate volatility is reduced. Although it can be argued from a theoretical standpoint that a floating currency should be a shock absorber, recent research suggests that fluctuations in the exchange rate may actually be a source of shock, at least in very small economies. Not only is exchange rate volatility greater, but the adjustment of the exchange rate returns less than no benefit in the form of a more stable real economy.[4]

All four of these explanations probably have some validity, but there is good reason to examine the fourth of these more closely. Why is exchange rate adjustment not a shock absorber in small countries, as in the textbook example, but rather a source of shock? There could be a number of explanations for this.

1. The tendency of exchange rates to fluctuate in excess of what appears to be warranted by fundamentals could be a contributing factor. In a sense, the exchange rate of a currency is an asset price and, as such, is determined by expectations vis-à-vis an uncertain future. Expectations can swing from euphoria concerning the expected future stream of foreign currency revenue from investment that will support a currency to despair and, in extreme cases, serious lack of confidence over a protracted period. Exchange rate movements have a more profound effect on the economy than do other asset prices, however. In addition to storing value, a currency is a unit of account and a medium of exchange. Fluctuations in currency exchange rates induces volatility of relative prices throughout the economy, particularly in small, dollarised economies, and elevate the risk of doing business.

---

[3] Increased aluminium production has also reduced the impact of commodity market volatility on the domestic employment level.

[4] See Francis Breedon, Thórarinn G. Pétursson, and Andrew Rose: *Exchange Rate Policy in Small Rich Economies,* Central Bank of Iceland, Working Paper no. 53.

2. The tendency of currencies to fluctuate beyond what can be justified by fundamentals has much wider implications in small currency areas than in large ones, as small currency areas are more dependent on foreign markets. When the exchange rate falls, the price level rises, relative prices change, and ultimately, wage levels are affected. Asymmetrical wage and price formation reduces the likelihood that the currency will recover in nominal terms; that is, nominal wage and price increases tend to reverse only partially as the currency recovers, making it less likely that the preceding depreciation will reverse in full. The result is high and unstable inflation, and inflation expectations that fail to be anchored to a low inflation target. Shallow markets and a limited number of participants make it difficult for firms to hedge against foreign exchange risk except for a very short period.

3. A private sector that is highly leveraged – largely in terms of foreign currency loans or CPI-indexed loans – exacerbates the problem associated with exchange rate instability. It exaggerates the procyclical tendency of the exchange rate; that is, it stimulates demand during upswings, when currency appreciation eases the debt burden, and deepens the contraction of demand during the downward cycle, as is evidenced by the contraction in the wake of the recent financial crisis. Overshooting of the exchange rate has caused enormous burning of assets and redistribution of wealth, more or less arbitrarily. The consequences of overadjustment of this magnitude can hardly be called "creative destruction", to use Schumpeter's turn of phrase. It is simply destruction that reduces the potential output of the economy.

4. According to textbook economics, exports should be stimulated when the domestic currency depreciates; hence relative wages become more competitive and domestic demand contracts. In theory, external shocks should therefore have a lesser impact on the domestic employment level than they would under a fixed rate regime. This probably applies to Iceland as well, to a certain extent. But there is reason to assume that the positive effect of currency depreciation on exports is less pronounced in very small countries, particularly those whose exports are of the same type as Iceland's. Iceland's chief export sectors – marine products and aluminium – cannot easily step up production for obvious reasons, irrespective of wage competitiveness. Iceland's export companies are generally specialised for exportation. Only a tiny share of their production is destined for the domestic market. As a result, they cannot easily step up exports simply by shifting a larger share of their production to overseas markets. The domestic market is simply too small to absorb a significant share of the production of a domestic firm that has achieved full economy of scale. In order to boost exports, Iceland's exporters must increase their production capacity through new investment, often with a long gestation period. A comparison with European countries that fared poorly as a result of the financial crisis shows that Iceland's exports have not grown more than those of euro area countries or those with fixed exchange rates. Actually, excluding seasonal effects, some of the fixed-rate countries have experienced greater export growth (Chart 2).

5. Actually, if exchange rate volatility is excessive and exporters are heavily leveraged in foreign currency, a large currency depreciation could conceivably have a negative impact on exports. Even though the depreciation has a positive effect on an exporter's cash flow, the balance sheet effects could make the company technically insolvent. This complicates access to credit, which may be a prerequisite for the expansion of exports in a small economy with specialised export production.

According to the above, my preliminary diagnosis is that the erosion of the value of the króna since its launch as an independent currency in 1920 can be traced to an inadequate monetary framework (particularly in the early years), general lack of discipline in economic policy-making, and the interaction of those problems with problems of running the world's smallest independently floating currency. In order to maximise the chance of recovery, all of these underlying weaknesses must be treated simultaneously, including the instability of the currency, as some of the prescribed medications for long-term reduction of exchange rate volatility are difficult to administer unless exchange rate volatility is reduced *first*. Although the Central Bank has announced its intention to intervene in the foreign exchange market more actively than it has in the past in preparation for lean times, such intervention should not be expected to have a profound or lasting impact on the exchange rate.[5] Other ways to reduce harmful exchange rate fluctuations should therefore be considered.

Negotiations are currently underway concerning Iceland's possible accession to the European Union and the Economic and Monetary Union (EMU), upon fulfilment of the Maastricht criteria. If there is no advantage to a floating exchange rate – or even less than no advantage – then there is clearly no benefit in delaying membership of the European Exchange Rate Mechanism (ERM II), which precedes full membership, provided that EU membership is approved in a national referendum and by member states.

How quickly Iceland fulfils the Maastricht criteria is primarily in the hands of the authorities and the social partners. In my view, the timing of membership will be determined primarily by how quickly the general government debt ratio can be lowered towards the Maastricht criteria. According to the formal requirements, general government debt must be less than 60% of GDP or fall quickly enough towards that target. Belgium, Italy, and Greece were admitted to the EMU with general government debt in excess of 100% of GDP – a decision now rued by many. Iceland will probably be subjected to more stringent requirements, for which I am tempted to be grateful.

On the other hand, there is no reason to despair over the task of reducing public sector debt to 60% of GDP. The target Iceland has set for itself in any case, partly by aiming for a fiscal surplus, which is stricter than the 3% deficit set forth in the Maastricht criteria. Although Iceland's gross public sector debt will be close to 100% of GDP as of end-2011, net debt is only about 40% of GDP. A large share of gross debt is due to large temporary foreign exchange reserves.

Once uncertainty about the removal of capital controls is behind us, the sovereign credit rating improves, and the refinancing risk related to foreign debt diminishes, the need for large foreign exchange reserves will diminish as well. Furthermore, as a member of a currency union, a small country needs smaller foreign currency reserves than it needs to run an independent currency, which it must be prepared to defend, and possibly provide domestic financial institutions with foreign currency liquidity during times of distress. Participation in ERM II, which entails reciprocal responsibility for exchange rate stability, would reduce somewhat the need for large foreign exchange reserves relative to a unilateral fixed rate regime. In addition, the Government owns substantial assets that it could sell in order to speed up the reduction of gross debt, including its stake in the banks.[6]

How Iceland would stand vis-à-vis the other Maastricht criteria, such as those pertaining to inflation, interest rate differential, and ERM II membership (for two years prior to accession) is also largely in the hands of the authorities. Through fiscal restraint, they could also contribute to the convergence of long-term interest rates. The social partners could promote low inflation by exercising restraint in wage settlements. Finally, the shorter end of the interest rate spectrum is determined by the market's self-fulfilling expectations concerning membership itself and by the decisions of the Central Bank.

Although a number of arguments indicate that currency union membership would suit Iceland well, it is not certain that a majority of the electorate will vote in favour of European Union membership in a national referendum. The fact that a number of EU member countries are in

---

5 Intervention would normally be sterilised in order to prevent undesirable effects on money supply. Hence the impact on the exchange rate is unlikely to be large or lasting.

6 According to current targets, the authorities aim to reduce gross public sector debt to 70% of GDP by 2015.

financial distress, not least those permitted to join the EMU through rather liberal interpretation of the Maastricht criteria, does not increase the likelihood that the referendum would pass. Although the performance of a currency union should be evaluated rather in the light of price stability, which is the principal task of the area's central banks (and where performance has been strong), than in the light of fiscal performance, which is the responsibility of individual member states, or financial stability, which – unfortunately – is still largely the province of individual member states, it is not unlikely that the problems facing the euro area will affect voters' choices. The looming financial and sovereign debt crisis in the periphery of the euro area poses a problem for the conduct of the common monetary policy that must be solved.

In the event that membership is rejected, it would be appropriate to consider other options. The measures I mentioned earlier could improve performance without radical changes. How successful they are will be determined to a large extent by the strength of political support for the reforms. For example, will those who consider the decisions of the independent Monetary Policy Committee "crazy" agree to place further tools at the disposal of the Central Bank or an independent financial stability committee? The combination of short-sightedness and populism that has long characterised economic and monetary discourse in Iceland is a roadblock to enhanced stability. Consequently, I am not optimistic that a modified fixed exchange rate regime, such as that pursued in Iceland before the inflation target was adopted in 2001, will be successful.[7]

In the event that currency union membership is not an option, the question arises whether it would still be desirable to remove the temptation and source of instability represented by a flexible or floating exchange rate, either through a currency board or through unilateral adoption of another currency. The preconditions for such radical steps to be sensible are much farther off on the horizon, however, than EMU membership, should that option become available. There are two primary reasons for this.

First of all, recent experience has demonstrated that the provision of central bank liquidity can determine whether a country's banking system survives a period of extreme stress. It failed to prevent the collapse of the Icelandic banking system, but many relatively healthy banks in Europe and elsewhere would probably have failed as well in the autumn of 2008, with all the economic and social cost implied, if their national central banks had not provided them with liquidity during the turmoil and were it not for cross-border co-operation among central banks. Therefore, I am of the view that unilateral adoption of a foreign currency or a currency board could only be considered prudent if all of Iceland's largest banks were owned by a strong foreign bank with the financial strength to provide them with liquidity during times of distress.

Second, unilateral adoption of another currency is a solution that is hardly worth considering unless EMU membership has been ruled out for the foreseeable future, as it entails extra cost of purchase of new base money for the banking system (generally in the range of 70–100 b.kr. in recent years) and larger precautionary foreign exchange reserves (particularly if the banks are not foreign-owned). It would be pointless to pay that price for a few years' benefit, plus the seigniorage that would revert permanently to the ECB.

Currencies other than the euro have also been mentioned. But considering the characteristics required of such a currency, there is no other that comes close to being as beneficial for Iceland as the euro is. The most important characteristics of such a currency are the following:

---

[7] Such a policy has proven successful in Denmark, but Denmark has a stronger economic framework than Iceland and enjoys ECB support through ERM II membership.

1. The share of the currency area in Iceland's external trade should be greater than that of other currencies and, preferably, Iceland should have a free trade agreement with the area in question that would contribute to economic integration with it.

2. The currency should be an international reserve currency, and the market for it should be deep enough to facilitate hedging against foreign exchange risk.

3. The currency area should be characterised by price stability and have a sound monetary policy framework.

Considering those characteristics, adopting any currency other than the euro would have serious drawbacks.[8] Therefore, reforming the current regime appears preferable to a radical change should EMU membership be unattainable, at least for the next decade. The fact that the vast majority of small countries either use another country's currency or pursue some type of rigid fixed exchange rate policy could indicate, however, that a floating currency may face difficulties over the long haul (Chart 3).

Ladies and gentlemen:

No monetary framework or choice of currency will solve Iceland's economic problems once and for all. The set of solutions labelled "cure-for-all-ills" is an empty set. Protracted discussions of the contents of an empty set are not only empty in themselves; they are absolutely pointless. Irrespective of the framework, economic policy must be pursued with greater discipline than has been the case to date. However, imposing a framework that forces the authorities to adopt more long-term oriented policies could improve performance. One way to do this is to join a currency union. The experience of Greece and other countries on the periphery of the EMU shows, however, that if economic policies remain short-sighted and solving imminent fiscal problems is delayed for too long, the imposed discipline is anything but palatable. I think Iceland's experience of its collaboration with the IMF indicates, however, that it would flourish under such discipline. But if EMU membership is not an option, that discipline must come from within. The reforms proposed by the Central Bank in two recent reports are designed to foster such discipline. In many instances, the same measures could contribute to stability and sustainable output growth as a member of a currency union and, in some respects, could be easier to implement from within it.

Thank you.

---

[8] The most viable option would perhaps be the Danish krone, provided that the authorities were willing to bet on its continued stability vis-à-vis the euro.

Below are the slides shown during the speech:

Chart 1

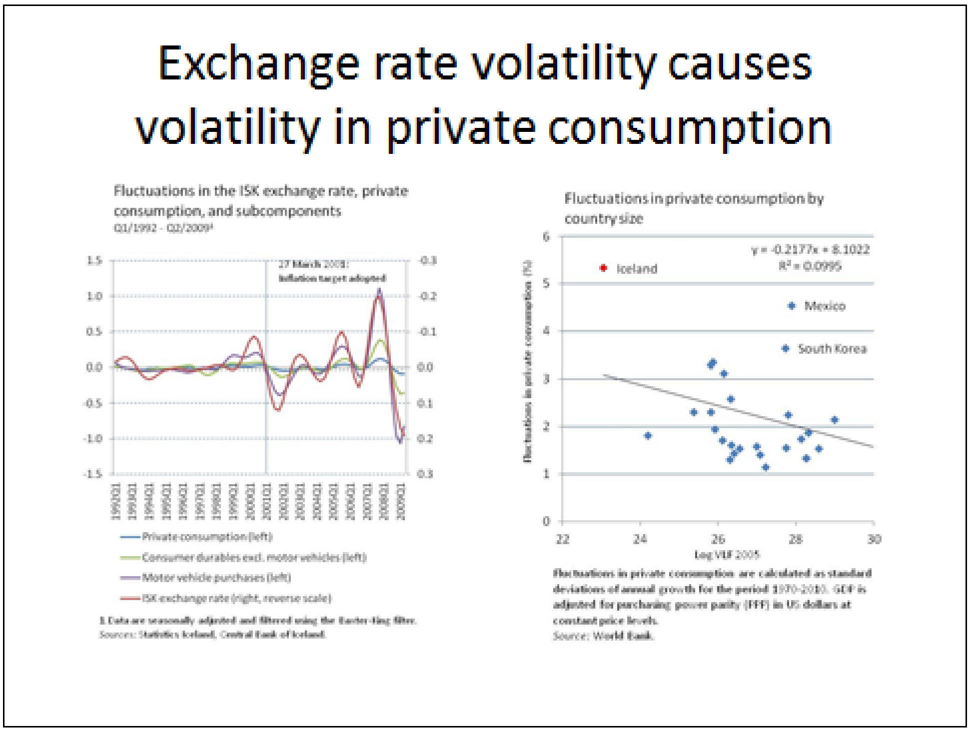


Chart 2

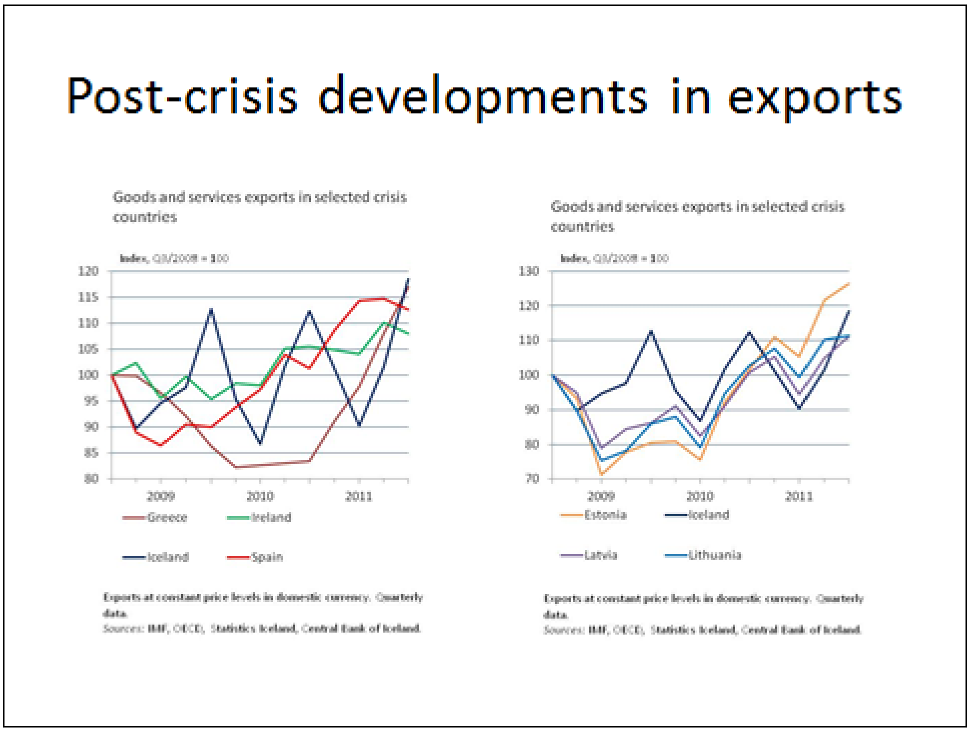
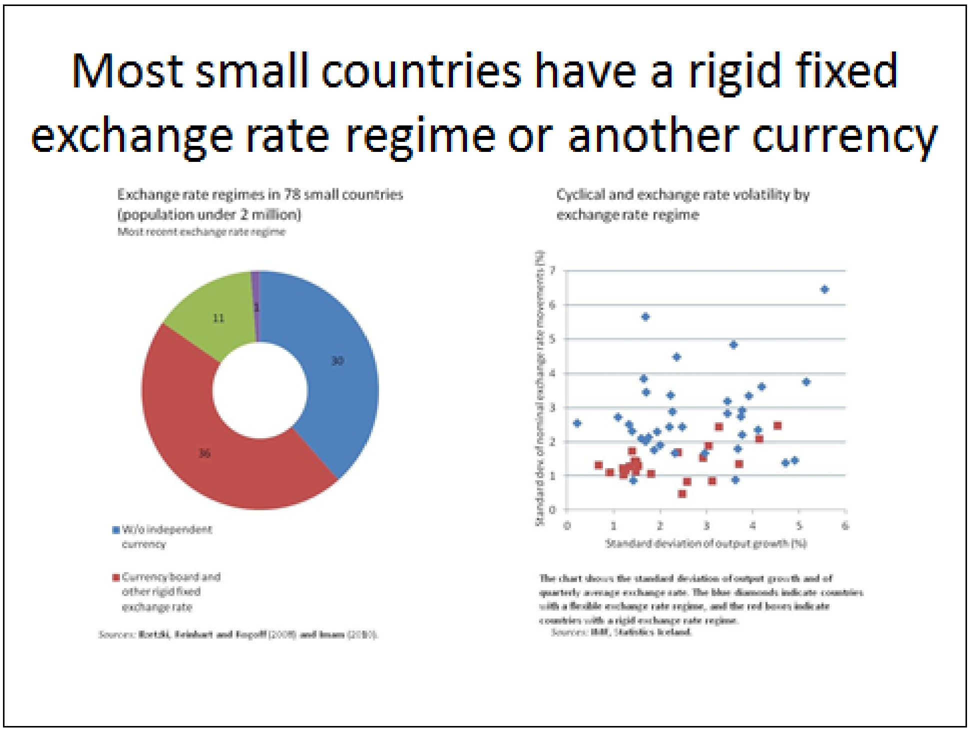


Chart 3



Most small countries have a rigid fixed exchange rate regime or another currency
Exchange rate regimes in 78 small countries (population under 2 million)
Most recent exchange rate regime
11
1
30
36
W/o independent currency
Currency board and other rigid fixed exchange rate
Sources: Ilzetzki, Reinhart and Rogoff (2008) and Imam (2010).
Cyclical and exchange rate volatility by exchange rate regime
Standard dev. of nominal exchange rate movements (%)
0
1
2
3
4
5
6
7
Standard deviation of output growth (%)
The chart shows the standard deviation of output growth and of quarterly average exchange rate. The blue diamonds indicate countries with a flexible exchange rate regime, and the red boxes indicate countries with a rigid exchange rate regime.
Sources: IMF, Statistics Iceland.