Ásgeir Jónsson: Address – 60th Annual Meeting of the Central Bank of Iceland

Address by Mr Ásgeir Jónsson, Governor of the Central Bank of Iceland, at the 60th Annual Meeting of the Central Bank of Iceland, Reykjavík, 7 April 2021.

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Madame Prime Minister, Chair of the Supervisory Board, honoured guests:

This year, 2021, can be called the Triple Crown of anniversary years for the Central Bank of Iceland. In 2021 we commemorate three earlier milestones in the Bank's history – 1961, 1981, and 2001.

The Central Bank became an independent institution in 1961 – and on this day, in fact: 7 April. So we are celebrating the Bank's 60th anniversary today. Until 1961, central banking activities in Iceland had been in the hands of two commercial banks: first Íslandsbanki and then Landsbanki Íslands. The establishment of the Central Bank was an element in the broad economic reforms introduced in the early years of the so-called Viðreisn government coalition – reforms that released Iceland from capital controls, goods rationing, and repeated currency exchange rate adjustments.

But 60 years is not an advanced age if we consider that Iceland became a sovereign country 103 years ago. With the grant of sovereignty in 1918, the Icelandic króna became an independent currency. It was not until 43 years later that a separate central bank was tasked with the conduct of monetary policy. It should come as a surprise to no one that economic policy was fairly unsuccessful over that time. The establishment of the Central Bank 60 years ago was a major step forward for the country: finally, it would be possible to pursue domestic economic policy in a systematic way.

The second of the Triple Crown anniversaries marks four decades since two zeroes were shaved off the króna and a new currency was effectively issued at the beginning of 1981. I remember clearly when the redenomination took place. I was 10 years old and thought it was great sport to have new money in my hands – new krónur, or course, but new aurar, too. Since the redenomination, all of Iceland's banknotes have been designed by Kristín Þorkelsdóttir, about whom we shall hear more shortly. Kristín's banknotes alone could have been considered reason enough to issue a new currency. But the real reason, and a far less sentimental one, was the persistent, entrenched inflation that engulfed Iceland, particularly in the 1970s. It stemmed from a number of causes, but the most important one was the fact that the Central Bank of Iceland did not have an independent mandate to apply policy instruments to combat it. And this brings us to the third anniversary we are celebrating in 2021.

This year marks the 20th anniversary of Iceland's inflation target, which is also the 20th anniversary of the 2001 legislation enshrining the Central Bank's independence in law. In 2001 I was thirty years old, and I remember the Central Bank's Annual Meeting held on 27 March, and the excitement in the air when the announcement was made. Those were challenging times. The Central Bank had been pursuing a fixed exchange rate regime with defined deviation bands, but Iceland was grappling with a growing current account surplus that reached 10% of GDP. And the country's foreign exchange reserves were not large enough to back that policy much longer. So it is hardly surprising that the króna depreciated afterwards and that the inflation-targeting years began with an inflation spike.

It was a difficult birth, and one that showed symptoms of having been a flight from the exchange rate peg rather than the embrace of a new monetary policy. But over the two decades that have passed since then, things have definitely moved in the right direction. The Central Bank's work

has grown and evolved – in analysis, forecasting, and transparency. Another milestone came not long afterwards, when interest rate decisions were placed in the hands of a separate Monetary Policy Committee in 2009. Over the years, monetary policy has gained credibility, which has enabled the Central Bank to support the economy handsomely during the pandemic by slashing interest rates and relaxing other monetary policy instruments, yet without materially deanchoring inflation expectations.

Honoured guests:

What do anniversaries and birthdays mean? Many are relieved to have survived for the number of years indicated by their birthdays, while others are merely reminded of how little they have accomplished and how little time they have left. This was how I felt, anyway, when I turned 50 last year, although others may scoff if they like.

On the other hand, institutions like central banks are not mortal individuals with a limited lifespan, and for them, birthdays and anniversaries are cairns marking a path with no obvious endpoint – a path that must point to the future, and to progress. The past only has meaning insofar as it illuminates the road to the future.

The inflation target that we observe now is a function of much more than merely keeping inflation at bay. The policy centres on setting the right ground rules between democratically elected representatives, on the one hand, and experts or officials, on the other. And it rests on the foundations of a simple division of labour: elected representatives define monetary policy objectives, and the Central Bank has the independent power to execute policy in the pursuit of those objectives. In this context, the Central Bank can be viewed as an independent contractor engaged by the people of Iceland.

The ground rules of inflation targeting have proven to be good ones for democratic countries, as inflation targeting demands transparency and public accountability, in line with the precepts governing an open society. Yes, inflation-targeting central banks work on a public stage and must be able to participate in public discourse in a dedicated and resolute way. In the final analysis, each is judged according to their actions.

Honoured guests:

There is no doubt that inflation targeting is the future for monetary policy in Iceland, as it is for other countries with monetary independence, even though targets may be modified along with the tools used to attain them. There was a time when it was believed that central banks could achieve their objectives by wielding a single weapon: seven-day interest rates. It was also believed that central banks should think only about the transmission of monetary policy to the real economy and let the financial system alone in other respects. In the narrowest sense, the task in hand was inflation, not asset bubbles. But this narrow policy was doomed to crash and burn, here as well as elsewhere. Monetary policy has been reformed and strengthened since then, and is sometimes referred to as inflation targeting-plus.

In May 2015, London Business School professor Hélène Rey published an influential paper bearing the title *Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence.* Rey argued that, because of financial integration, independent monetary policy was actually no longer an option for small currency areas unless it was possible to manage the capital account directly or indirectly, no matter what exchange rate regime was pursued.

The chain of events is familiar to all of us: As soon as a small central bank applied its policy instruments in an effort to cool down the economy – such as by raising interest rates – it would open the floodgates to a tidal wave of capital inflows that would cause the economy to flounder. And by the way, in this context nearly all central banks worldwide are considered small, apart from the US Federal Reserve and the European Central Bank.

It is important to bear in mind that the problem is created not only by foreign exchange market instability; capital inflows can overwhelm the financial system and create credit and asset bubbles like those we saw in Iceland in 1998–2000, and again in 2004–2008. And at some point in time, this capital will want to go back home – sometimes with no advance warning – leaving ruin in its wake. Therefore, it should come as no surprise that, in open economies with independent currencies, currency crises and banking crises usually go hand-in-hand in what are called twin crises.

Hélène Rey proposed four options to create scope for monetary policy:

1. Targeted capital controls, to create space for independent monetary policy without disturbances from abroad;

2. International coordination of monetary policy, particularly the policy of the Fed and other large central banks;

3. Steering monetary policy transmission by applying macroprudential tools in order to control credit growth and leverage;

4. Protecting the financial system with strong financial supervision and stricter limits on leverage, so as to prevent the use of foreign capital for financial gymnastics.

In my view, the first two of these are either unfavourable or unfeasible for Iceland. Capital controls are costly from a social welfare perspective, especially in small countries that are reliant on cross-border trade – be it trade in goods, in services, or in capital. Capital controls can also give rise to oligopoly in the financial markets, as well as leading to inefficient price formation and causing persistently high interest rates. Imposing capital controls has to be considered the last resort – a line of defence to be reserved for when financial stability is under threat. And after having seen the responses of individual countries to the COVID-19 pandemic, I have little confidence in international coordination of monetary policy.

Applying macroprudential tools and financial supervision in a system-wide context therefore entails weakening the incentives for short-term capital to flow into the economy, and preventing the capital flows that do occur from upending the system. In this way, we can create stronger foundations for independent monetary policy in small open economies. We need revetments, not restrictions.

Actually, I do believe that large international reserves and systematic use of the central bank balance sheet can give small economies a certain flexibility to set their own monetary policy by leaning against movements in the capital account, as we have done here in Iceland. In 2020, the Central Bank sold foreign currency in the amount of 144 b.kr. in order to prevent lower interest rates from causing excessive, unwarranted depreciation of the króna. It is also possible to imagine that, in the future, the Central Bank could absorb excess capital inflows into Iceland if this should prove necessary. In the future, the Central Bank will need to use its balance sheet to ensure effective monetary policy transmission and ward off potential financial side effects.

Nevertheless, in the long run, the future of monetary policy lies in using a greater number of policy instruments and in coordination with macroprudential policy and financial supervision. Here lie the opportunities for Iceland’s tiny currency area.

Honoured guests:

Yet another anniversary is uppermost in my mind today: the one-year anniversary of the merger between the Central Bank and the Financial Supervisory Authority – the reunification, we could say. The Financial Supervisory Authority was once part of the Central Bank, called the Banking Supervision Department. But in 1998 the banking supervision function was carved out of the

Bank, right around the time the two State-owned banks were being prepared for privatisation. The senior management of the Central Bank protested vehemently against the separation, and I would like to quote from a letter on the topic, sent by the Board of Governors to the then Minister of Commerce in early 1998:

> *"The Board of Governors is of the opinion that there are overwhelming arguments in favour of the Central Bank's continued supervision of the activities of deposit institutions, other credit institutions, and securities market entities. The Board of Governors wishes to emphasise in particular that such supervision is a normal and appropriate part of the Central Bank's activities. This supervisory role benefits just as much from its partnership with the Central Bank as various other Bank activities do from partnering with banking supervision."*

If there is any single factor that foreign experts have identified as the main cause of the 2008 financial crisis, it is the fact that responsibility for and supervision of the financial system were spread across a large number of ministries and institutions, with the result that no single party had an all-encompassing overview, no single party was actually accountable, no single party had adequate power, and no single party had enough muscle to intervene. Actually, in other countries where financial supervision had previously been hived off from the central bank, the two functions were reunited after the 2008 crisis. The Ministry of Commerce was united with the Ministry of Finance for the same reason: to enhance the punching power of financial and economic administration.

And now, in Iceland, financial supervision and other central bank activities have joined forces again, after a separation of 22 years. Now we have a single institution that is responsible for financial stability and has information on the financial system and developments in systemic risk within that system. The reunified Central Bank has far more explicit authorisations to intervene when events warrant it. It now has to power to affect the behaviour of financial institutions and market agents for the better. Unfortunately, the Icelandic language, rich though it is, still lacks a good enough translation of the English word "prudence", which encompasses all that we hope to elicit in supervised financial market entities' behaviour. We need a word that captures the concepts of foresight and thrift.

I would like to reiterate what my predecessors said in the aforementioned letter to the Minister of Commerce: Supervision is a normal and appropriate part of the Central Bank's activities. This supervisory role benefits just as much from its partnership with the Central Bank as various other Bank activities do from partnering with banking supervision.

We have seen this in action. The year or so since the merger took effect has been a busy one, but it has proven the value of joining forces – in case anyone was in doubt before. For example, the integration of data and intelligence has been demonstrably beneficial during the pandemic, allowing increased oversight, improved analysis, and harmonised responses.

It has been my unwavering objective to achieve full integration between financial supervision and the Central Bank's other activities as quickly as possible, so as to strengthen supervision, monetary policy, and financial stability in Iceland.

We have made good progress thus far, and we look forward to continuing on our shared path.

Honoured guests:

As I mentioned, Icelanders have been independent politically and economically for just over a century, even though the Central Bank is only 60 years old. Over this period, we have tried out virtually all versions of monetary policy: a currency union, a pegged exchange rate, a crawling peg, a floating exchange rate, and inflation targeting. Each of these monetary policy regimes has its advantages and disadvantages. But what matters most is that each of them requires a certain

institutional structure, and each requires that the Government and others follow specified and appropriate ground rules. If we have had problems running independent monetary policy, it is not necessarily because the policy itself has been wrong. It is far more likely that we have not followed the rules or have not had the right institutional architecture in place.

Indeed, if we think the history of monetary policy in Iceland has been a thorny one, we should remember that we started out with a central bank that effectively didn't exist until 1961, and until 2001 we had a central bank that did not have the independence it needed to apply its policy instruments effectively. And from then until last year, we had a central bank that had been deprived of the authority to intervene in the functioning of the financial system.

But the Central Bank is not alone on the stage. Sound economic policy is a triumvirate comprising the Central Bank, the Treasury, and the labor market partners, all of which must work together to keep the economy in balance. These three members of the triumvirate must act in concert in order to ensure stable prices, stable purchasing power, and low interest rates for the long term. We can do this just like other countries can. We will do it. And the Central Bank will do its part.

Sixty years of Central Bank operations should give us a reliable roadmap to the future. We who work for the reunified Bank are champing at the bit in our excitement to take on the tasks that await us.

Now let us watch the video about the design of Iceland's banknote series, in commemoration of the 40th anniversary of the redenomination of the Icelandic króna.

Thank you