Ásgeir Jónsson: Speech – 64th Annual Meeting of the Central Bank of Iceland

Speech by Mr Ásgeir Jónsson, Governor of the Central Bank of Iceland, at the 64th Annual Meeting of the Central Bank of Iceland, Reykjavík, 10 April 2025.

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

An hour before noon on Friday 15 April 1904, all stores in Reykjavík were closed, and children were given the day off school. At noon, city merchants gathered at the square in Lækjartorg and "marched" to the tune of band music to the cemetery on Suðurgata. The weather was delightful, and the Icelandic flag, which was then blue and white, and the Danish flag were held aloft as the parade moved along. When it reached the cemetery, a garland was placed on the grave of Jón Sigurdsson, speeches were given, those gathered sang "Ó Guð vors lands [O God of our Land]", and the group returned to midtown.

That parade marked the fifty-year anniversary of free trade and the end of the Danish trade monopoly, the last vestiges of which had been lifted on 15 April 1854. The celebrations continued through the evening with gatherings all over town. Freedom was eulogised with a nineteen verse "ode to trade freedom" written by editor and Alaska explorer Jón Ólafsson. The last verse translates loosely as follows:

Let freedom to trade be the beacon that guides us

and helps us change boulders to bread.

Let freedom to trade be the bedrock beneath us,

the bulwark of freedoms ahead.

Independence leader Jón Sigurdsson had certainly prioritised free trade. In 1843, he wrote an article for the magazine Ný félagsrit [New Association Writings] entitled "On Trade in Iceland", in which he explored Icelandic history through the lens of classical economics in the spirit of Adam Smith and David Ricardo. He attributed Iceland's poverty to the Danish trade monopoly, thereby staking out a new political policy: Free trade would be a cornerstone of Iceland's sovereignty. The 1904 event was therefore a victory celebration, as much had been gained over the preceding half-century. Iceland had home rule and a new bank registered in Copenhagen. Motorised boats and urbanisation were just over the horizon. Perhaps more importantly, the Icelandic nation had gained the confidence to stand on its own feet.

Honoured guests:

The period from 1860 until 1914 is often referred to as the First Globalisation – when trade in goods and capital was unrestricted and countries were interlinked by railroads, steamships, and the telegraph. The British were in the vanguard of global trade at that time, harnessing their industrial power, their might as a colonial empire, and the strength of the gold-pegged pound sterling.

This openness came to an end with the outbreak of World War I in 1914. The US took the helm from Britain as the twentieth century's leading industrialised country but did not take the lead in world trade. This became obvious after the stock market crash of October 1929. In June 1930, the US responded by levying protective tariffs of 20% on the rest of the world. Other countries immediately responded in kind and world trade shrank by 60-70% over the ensuing two years, undeniably deepening the Great Depression.

Iceland's fight for independence was grounded not least in its having unrestricted access to foreign markets. It was in the shelter of this certainty that the nation chose to separate from Denmark and become a sovereign state on 19 October 1918. A mere 23 days later, on 11 November 1918, World War I ended with the signing of an armistice agreement on the Western Front, and soon afterwards, Europe stopped buying Icelandic herring. Iceland was close to insolvent by October 1920, and consumer goods had to be rationed in Reykjavík over the ensuing winter. The situation was only remedied after the króna had been devalued by 30% and a loan from Britain obtained – on onerous terms.

Only two years after having gained sovereignty, Iceland had been battered by the fragility of international trade. Numerous shocks have shaken the country since then, and we have usually been poorly prepared for the headwinds. Perhaps it is not in Icelanders' nature to make hay while the sun shines, as we are advised in to do in the Book of Proverbs. I believe the COVID pandemic in 2020 was the first and only severe shock we have weathered without staring down the barrel of a balance of payments crisis, a currency implosion, the imposition of capital controls, or goods rationing. But our relative strength in 2020 did not materialise out of nowhere.

Honoured guests:

Ever since the financial crisis struck in October 2008, we as a nation have given top priority to shoring up the economy's resilience to external shocks. Of course, this is not the work of any single individual but a joint effort involving many, many people. With the passage of the new Central Bank Act in 2019 and the merger between the Bank and the Financial Supervisory Authority in 2020, Iceland endeavoured to integrate monetary policy, macroprudential policy, and financial supervision into a comprehensive strategy. Five years after the merger, the boundaries between the two institutions have vanished, but the improvement is plain to see.

Anyone who doubts the efficacy of macroprudential tools should read the Bank's most recent Financial Stability report, issued this March. According to the analysis in that report, households' and businesses' balance sheets have seldom been healthier than they are right now, owing to moderate debt levels and ample equity. There are few signs of increased arrears as yet. Iceland's balance of payments is broadly satisfactory, and the króna has been relatively stable. In short, we are very well prepared to face headwinds.

The application of macroprudential tools has also supported monetary policy effectively by restricting both debt levels in the real estate market and derivatives contracts in the foreign exchange market. It has enabled us both to prevent bubble formation amidst rising house prices and to limit opportunities for speculation and carry trade in the wake of a significant tightening of the monetary stance. It is also clear that capital requirements on credit institutions strengthen the transmission of the monetary stance along the credit channel by limiting the multiplier effects on deposits and lending, or the money creation associated with increased leverage.

The Central Bank has now lowered its key interest rates four times since last autumn, and inflation has been on a more or less constant downward path for well over a year. Although inflation is still too high, it is moving steadily towards the 2½% inflation target. Monetary policy works. As long as private sector balance sheets remain strong and resilience is sufficient, it is quite likely that the economy will achieve a soft landing after a period of very buoyant GDP growth. This is the scriptural lesson that truly matters.

Honoured guests:

The voices insisting that we as a nation cannot afford the macroprudential buffers we have accumulated in recent years have grown ever louder. Icelandic banks, they say, are fenced in and their competitive position weakened by excessive capital requirements. Resolving this would involve either bank mergers or a relaxation of capital requirements. In this context, I want to ask everyone to pause for a minute and look back over the past five years, and to recognise that it is indeed possible to strengthen operations without increasing leverage and indebtedness in the system.

In 2019, the three systemically important banks' net interest income totalled 100 b.kr. or so. By 2024, it had grown to 150 b.kr. This is an increase of 16% in real terms. Over the same period, the banks' operating expenses rose by 7 b.kr., which is equivalent to a decrease of 19% in real terms. Their expense ratios in terms of regular income fell from 57% in 2019 to 43% as of 2024. Their interest rate spreads have held broadly unchanged. Simply put, this is a revolution in Icelandic banking operations! And no wonder that the three banks' returns were twice as strong over the past four years as over the four-year period immediately preceding. In 2017-2020, the banks' average returns were 5.7%, but in 2021-2024 they were 11.7%. Strong returns and strong macroprudential policy therefore go hand-in-hand!

I cannot resist quoting the closing line in Voltaire's Candide: "We must cultivate our garden." It seems crystal-clear to me that the three large banks have made astonishing progress in cultivating their gardens over the past five years – and that a host of opportunities still await them.

I want to emphasise here that the best foundation for sound long-term returns in the financial system is economic policy that ensures stability. This should be obvious – and it is a lesson we ought to have learned many times over. The heart of the matter is this: Strong macroprudential policy and robust financial supervision create more stable revenues for the financial system and reduce the likelihood of loan losses and collapse. Macroprudential tools lay the groundwork for preventing competition in the lending market from devolving into a game of leapfrog where participants vie with each other to see who can make the most lenient requirements, as was the case during the years preceding the collapse of 2008. Being a systemically important bank in a small system brings with it both responsibilities and benefits, which must inevitably be reflected in higher capital requirements. But I want to mention that just this winter the Central Bank lowered capital buffers on Icelandic financial institutions not designated as systemically important. This is a reflection of the Bank's assessment that systemic risk has subsided with the application of macroprudential tools.

I also want to emphasise the importance of financial supervision for the credibility of the financial system, where transparency is a key to trust. It is vital to monitor risks within individual institutions because temptation within one entity can so easily become another's problem. In this context, it is important that we be able to investigate such cases and conclude them appropriately without giving rise to doubts about the financial system or the market as a whole. It is also important that we increase the efficacy of supervision to the extent possible, given the international commitments we have undertaken under the EEA Agreement. I would like to point out that the capital requirements imposed on Icelandic credit institutions due to specific credit risk have declined in recent years, partly because the banks' loan books are far better diversified and carry less concentration risk now that the share of real estate-backed loans has increased. The outlook is also for capital requirements due to mortgages with relatively low loan-to-value ratios to decline even further with the implementation of the third Capital Requirements Regulation (CRR III) in coming months.

Not only have real estate-backed loans generated secure interest income for the banks and reduced capital requirements, they have also created new, favourable possibilities for foreign funding. I am convinced that, once the dust settles after the period of rapid price rises and supply shortages in the housing market, we will see continued growth in the banks' mortgage lending, similar to that seen in neighbouring countries, and Icelandic households will then be able to borrow on the best possible terms. It is very important for the Government to support this loan form – one that is funded with deposits, on the one hand, and covered bonds, on the other – instead of launching a new system and/or sponsoring large-scale State-guaranteed lending. In this context, we should be chastened by the past, for the Housing Financing Fund's remaining assets are hopefully being settled virtually as I speak, and at a large loss to the Treasury.

Honoured guests:

From the beginning of Iceland's sovereignty in 1918 until November 2008, the country's international reserves were too small to enable us to weather large external shocks. We changed course with loans taken in cooperation with the IMF in the wake of the financial crisis. But it was not until the Central Bank embarked on large-scale foreign currency purchases in the domestic interbank market in 2014-2017 that we acquired sizeable reserves financed in Icelandic krónur. These purchases created a glut of liquidity in the monetary system. Subsequently, the Central Bank's key interest rate became its deposit rate rather than the rate on collateralised loans. Instead of receiving interest income from its collateralised loans to the banks, as it had previously, the Central Bank paid interest on banks' deposits. If foreign interest income on the reserves were enough to cover these payments of deposit interest, the Central Bank's finances would be broadly in balance. As things stand, however, interest rates on deposits with the Central Bank have far exceeded returns on the reserves, owing to Iceland's interest rate differential with abroad. Furthermore, because of their prudential role, the reserves are invested in high-quality liquid assets, which generally yield lower returns than higher-risk assets would. This, in turn, entails a negative interest rate differential for the Central Bank and has eroded its capital in recent years. In 2024, the Bank took measures to curb this trend, as I explained in my speech at the Bank's annual meeting a year ago.

The shift was of direct benefit to the commercial banks. The foreign currency purchases of previous years expanded the stock of deposits and liquid assets in the system. Thus the banks' gross interest income is higher than it would be otherwise, which should reduce their average expenses. Furthermore, financial institutions enjoy risk-free returns on their accounts with the Central Bank. The benefits of this stem from the difference between the deposit interest the banks pay to their customers and the deposit interest they receive from the Central Bank. Here it is worth noting that liquid assets such as the banks' deposits with the Central Bank are not subject to reserve requirements. In view of all this, it should be beyond doubt that the commercial banks derive a net benefit from the past few years' glut of liquidity in the Icelandic monetary system – not to mention the international reserves themselves.

The advantages of large reserves should also be patently obvious. The reserves confer benefits such as improved credit ratings, easier access to foreign credit markets, and better interest rate terms, and moreover, they are available to ensure liquidity in the foreign exchange market when needed. The commercial banks benefit in particular, as they are the only domestic entities apart from the Treasury and State-owned companies that have issued bonds in foreign credit markets. The direct advantage to the three banks can be seen, among other things, in last year's credit rating upgrades and in more favourable interest terms abroad, which ultimately deliver benefits to the banks' customers.

The international reserves currently total 865 b.kr., or 19% of GDP. They are held jointly by the Central Bank and the Treasury, although of course, the Icelandic nation is ultimately the owner. The 300 b.kr. worth of reserves owned by the Treasury are actually borrowed, as they are financed with foreign bond issues. The Central Bank's share in the reserves, which are financed primarily in krónur, comes to 565 b.kr. At present, the Bank and the Treasury bear the cost of the reserves jointly, together with deposit institutions via the 3% reserve requirement.

The Bank bases its assessment of the optimum size of the international reserves on the IMF's reserve adequacy metric, or RAM. The Bank's current assessment is that the reserves should not be below 120% of that metric. The reserves have shrunk in recent years, and their funding has changed markedly, owing in particular to the Bank's programme of foreign currency sales during the pandemic and the Treasury's foreign currency need. In 2024, the reserves were equivalent to 118% of the RAM. The outlook is for the reserves to shrink marginally in the coming term, all else being equal, owing to foreign payments made by the Bank on the Treasury's behalf. The Central Bank is therefore of the opinion that the reserves need to be strengthened. As a result, and as a step in that direction, the Bank will initiate a new programme of regular foreign currency purchases in the domestic interbank market on 15 April 2025, the 171st anniversary of free trade in Iceland. The Bank plans to buy a total of 6 million euros, the equivalent of 870 b.kr., each week. The programme will be explained in more detail in a press release posted on the Bank's website.

Honoured guests:

The foundations for the post-war renaissance of free global trade were laid at a conference of 44 nations in the small US town of Bretton Woods, New Hampshire, in July 1944. Iceland was among them. At the Bretton Woods conference, the groundwork was laid for the establishment of the International Monetary Fund, the World Bank, and the so-called Bretton Woods fixed exchange rate system. Three years later, groundrules were created for the cancellation of tariffs and quotas in world trade with the signing in 1947 of the General Agreement on Tariffs and Trade, or GATT Treaty. In a total of eight rounds of negotiations, the world was opened up again, and GATT led to the establishment of the World Trade Organization in 1995, a year after the North American Free Trade Agreement (NAFTA) came into being.

The political capital for the endeavour came from the US, as did the political conviction that trade liberalisation was the only way to guarantee world peace and that big countries should not strong-arm smaller ones by levying tariffs on them. This perspective on the link between peace and free trade has been a leitmotif in US foreign policy for over 80 years – until 2025, that is.

It is unclear what short- and long-term impact the tariffs introduced by the current US administration this April will have on the global economy or on the future of liberalised world trade. It is obvious, though, that the side-effects will be felt not least by the American people, who have benefited enormously from free international trade.

I firmly believe in common sense: World trade will adjust to a new reality and will continue to grow. That does not change the fact that we Icelanders must always be prepared to respond to shocks and changed circumstances – to ensure the resilience of our economy. There is no question that strong macroprudential policy enabled us to weather the COVID storm without significant problems. And we have recouped our previous output capacity with 20% accumulated GDP growth since 2020. With this in mind, I want to encourage stakeholders and elected officials alike to avoid short-sightedness. Solid macroprudential policy is a good investment for the Icelandic nation.

It would be highly appropriate for us to gather at Lækjartorg next Tuesday, the 15th of April, walk together to Jón Sigurdsson's grave in the cemetery, and celebrate the abolition of the Danish trade monopoly. Jón's political policy – that free trade is a cornerstone of sovereignty and prosperity – is still valid.