Ásgeir Jónsson: When mice can roar - how to move fast without breaking things

Keynote speech by Mr Asgeir Jonsson, Governor of the Central Bank of Iceland, at the Reykjavik Economic Conference, Reykjavik, 9 May 2025.

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It is a great honour to address such a distinguished audience at the Reykjavik Economic Conference, which includes governors from some of the world´s biggest central banks. The Central Bank of Iceland is in all likelihood the smallest central bank in the world that implements its own, independent monetary policy. Iceland's population stands at just 400,000 – and the economy is roughly one-thousandth the size of the US. Today, I will focus on how we have coped with the many challenges facing a small economy in the face of shocks, both external and internal.

Like most countries, Iceland was hit hard by the COVID-19 pandemic. The economy suffered a serious shock, given the very heavy reliance on tourism. However, in its aftermath, Iceland once again demonstrated its remarkable resilience and has more than recovered all the output losses which it suffered. In fact, post-covid growth has been very rapid, or almost 20% in real terms over a span of four years. This growth performance is virtually unmatched among other advanced economies.

The tourism sector rebounded sharply, and now welcomes more than two million foreign visitors annually. Foreign direct investment is also flowing into the country, supporting growth in key sectors such as aquaculture, data centers serving AI applications and the pharmaceutical industry.

This robust growth has put considerable pressure on the labour market. Wages have risen steadily, which in contrast to other advanced nations has boosted real wages. In most other European countries, real wages have in fact declined in recent years. Our labour force has nevertheless been expanding at a fast pace, both through natural growth and immigration from abroad.

Notably, Iceland has one of the highest female labour force participation rates in the world, at above 75%. Foreign workers, primarily from Eastern Europe and the Baltic countries, have integrated well into the Icelandic labour market. Many have settled permanently, investing in housing for their families and contributing meaningfully to the economy. However, this development has also intensified pressures in the housing market.

The construction sector is visibly booming, as evidenced by the many cranes dotting Reykjavík's skyline. Yet, despite the increase in building activity, housing supply has not kept pace with demand. Real house prices have increased by 20% over the last five years.

To address overheating in the housing market and rising inflation, the Central Bank significantly tightened monetary policy and tightened borrower-based measures. As the Deputy Governor of Monetary Policy noted earlier today, long-term inflation expectations rose above target, prompting a steep increase in interest rates, the policy rate eventually reaching 9.25%.

Over the past year, the Bank has kept the real policy rate close to 4%, well above the estimated natural rate of 2.25%. This exceptionally tight monetary policy stance has been necessary to contain inflationary pressures and reduce inflation. While inflation is gradually declining, the process has taken longer than in other advanced economies. Unlike much of Europe, where inflation was driven by spikes in energy prices, Iceland's inflation was largely domestic in origin – stemming from labour shortages, rapidly rising wages and housing market dynamics.

Thanks to recent progress in lowering inflation, the Bank has cut rates four times, bringing the policy rate down to 7.75%. This remains high in nominal terms, but it marks the beginning of a cautious normalization path.

At the beginning of the tightening cycle, we moved largely in step with other central banks. However, as inflation became more entrenched, we had to raise our rates further than other advanced economies, by an additional 4 percentage points. This created a significant interest rate differential with our main trading partners.

Interestingly, while short-term interest rates diverged, long-term interest rate differentials have remained relatively stable. The differential on 10-year government bonds has held steady at around 2 percentage points versus the US and the UK, and about 4 percentage points versus Germany. These rate differences between the larger economies reflects to some extent fiscal factors.

Although fiscal policy in Iceland should ideally have been tighter, public debt to GDP remains moderate, and unlike many advanced economies, the Central Bank of Iceland did not engage in quantitative easing (QE) during the pandemic. As a result, the Bank does not hold any domestic bonds and therefore has not needed to unwind such holdings through quantitative tightening (QT).

Even as we raised short-term interest rates, long-term rates remained relatively stable. The fundamental challenge faced by small open economies that pursue an independent monetary policy is that high policy rates often attract speculative capital inflows or arbitrage trading. This was one of the key vulnerabilities during the global financial crisis.

Hélène Rey argues in her paper *Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence* that the only central bank in the world with true monetary independence is the US Federal Reserve. Other central banks must, to some degree, respond to US monetary policy due to capital flows.

Three main strategies are proposed for or managing this so-called "global financial cycle," particularly for small open economies:

1. *Capital Controls* – While effective, we view this approach as suboptimal and use it sparingly
2. *Foreign exchange Interventions* – The Central Bank of Iceland has engaged in FX interventions when deemed necessary, but reserves are finite and must be used judiciously in defending the currency. The Bank has also engaged in

periodic regular sales or purchases of foreign exchange in the interbank FX market - sold for the purpose of increasing liquidity in the market during the Covid – and bought for the purpose of bolstering the reserves – as is currently being done.
3. *Macroprudential Tools* – These remain our preferred option. By focusing on domestic vulnerabilities, such tools allow us to reduce systemic risk without distorting cross-border flows.

Iceland's experience illustrates the importance of a flexible and integrated policy framework. We must remain vigilant, nimble, and ready to use a range of tools to safeguard economic and financial stability-especially in a small, globally connected economy.

The Central Bank merged with the FSA in 2020, about half a year after I assumed the position of Governor. This structural reform granted the Bank sole responsibility for monetary policy, financial stability, and financial supervision and regulation. To my knowledge, no other central bank has been entrusted with such a broad and comprehensive mandate in the pursuit of national stability.

To deliver on this mandate, we have been careful to maintain clarity of purpose. The Central Bank Act provides for three distinct policy committees. The Monetary Policy Committee is tasked with maintaining price stability, guided by a 2½% inflation target set jointly by the Government and the Bank. The Financial Stability Committee makes macroprudential decisions to contain systemic risk and ensure the resilience of the financial system. Finally, the Financial Supervisory Committee oversees regulatory and supervisory decisions that ensure the soundness of financial institutions. Our institutional model draws in part from the Bank of England but has been tailored to suit the challenges of a small, open economy.

One of our primary goals has been to manage the Icelandic króna in such a way that its value reflects underlying fundamentals, such as external trade conditions and monetary policy, rather than speculative forces. We refer to this as "delinking the currency." In practice, it means implementing measures that reduce the scope for short-term capital inflows to distort exchange rates or financial conditions.

To that end, we have limited the ability of domestic entities to accumulate short-term external debt. We have also placed constraints on the use of derivatives, such as FX forwards and futures, by capping banks' forward positions at 50% of their equity. This reduces the potential for carry-trade strategies to exploit Icelandic interest rates through synthetic exposure to the króna.

While we welcome foreign direct investment and allow foreign participation in our bond markets, such transactions must take place through the FX currency market. This ensures that all capital flows are reflected in market pricing. The problem with synthetic or off-market contracts is that they allow the buildup of substantial positions, either long or short, without sending a corresponding price signal. Our guiding principle is that all foreign investment should be visible and priced in the respective markets, foreign exchange, bonds, or equities.

We have seen healthy FDI flows in recent years, and the system has held up well. At the same time, we maintain a last line of defense: policy tools designed to act as "speed bumps" on capital inflows, similar to the Chilean model. These have not been deployed recently but remain available if needed.

A second major objective has been to ensure sustainable growth of credit. Within the constraints of the European regulatory framework, we have maintained high capital requirements for banks-capital ratios are around 20%, including a 2.5% countercyclical buffer. These requirements serve not only as a buffer against risk, but also as a lever on money creation. For banks, capital is the key constraint on lending, and therefore on deposit creation. In that sense, capital regulation is a powerful tool for macroeconomic management.

We have also employed borrower-based measures-capping loan-to-value and debt service-to-income ratios. While these measures have not entirely brought housing price inflation under control, they have helped dampen it and to contain household leverage. Of course, households often find ways to circumvent such limits-parents assisting children with down payments, for example-but overall, these tools have served their purpose. Additionally, we have imposed restrictions on foreign-currency lending to entities without export earnings, thereby reducing vulnerability to currency mismatches. As part of our emergency powers passed during the 2008 crisis, the Central Bank now has the authority to intervene directly in specific financial institutions when necessary, ensuring timely and decisive action.

Our third major focus has been on preserving public trust and enforcing proper conduct in the financial system. This is a hard-earned lesson from Iceland's previous financial crisis: trust must never be taken for granted. The legitimacy of the financial system rests on its transparency, fairness, and accountability.

We have pursued this through several avenues. First, we target both systemic and systematic risks-such as cross-lending, cross-ownership, and lending to related parties. We have introduced strict fit-and-proper rules for board members and executives, placed caps on bonuses, and added capital requirements for lending to high-risk entities such as holding companies. Furthermore, we are committed to transparency: supervisory actions are disclosed, and enforcement measures-ranging from sanctions to direct interventions-are clearly mandated and actively used.

Despite elevated interest rates, we have managed to maintain a stable currency and a sound balance of payments. Icelandic banks remain profitable and well-capitalized. The economy has experienced robust growth, and importantly, this has been achieved without triggering a credit boom or financial instability. We believe this demonstrates that policies focused on resilience and long-term sustainability need not come at the cost of growth or profitability-provided they are transparent, consistent, and well-communicated.

We have also witnessed significant deleveraging across both the household and corporate sectors. Today, Iceland's private sector is relatively lightly indebted and benefits from a low tax burden. In terms of GDP, private sector indebtedness is in fact low in a historical context as well as an international one. This strength has contributed to the economy's flexibility and capacity for continued growth. In particular, the housing market has seen substantial household equity accumulation, which could have easily turned into a speculative credit cycle. Instead, we have observed rising savings rates-an encouraging signal of financial prudence.

From a broader perspective, we draw inspiration from the Tinbergen Rule: to achieve multiple policy objectives, one must have an equal number of independent instruments. Many policy failures stem from trying to accomplish too much with too little. At the Central Bank of Iceland, we are acutely aware of the risks of overreaching our mandate. For example, housing policy ultimately lies with the government-not the Central Bank.

Our emphasis, instead, is on institution-building: creating clear, independent, and accountable bodies that are empowered to act. We also recognize that the line between monetary policy and macroprudential tools is often blurred, just as the distinction between micro- and macro-supervision is increasingly ambiguous. Consider the case of Silicon Valley Bank in the United States-a regional bank not deemed "too big to fail" - whose fall nevertheless had systemic consequences. This underscores the need for a unified and flexible approach.

We believe strongly in an integrated policy framework. Monetary policy, financial stability, and supervision are not isolated functions-they are deeply interdependent. A successful monetary policy requires sound macroprudential policy, which in turn depends on vigilant and credible financial supervision.

Perhaps the greatest advantage Iceland gained from the crisis of 2008 was the opportunity to rebuild from scratch. We took that opportunity seriously and created institutions that are more resilient, more transparent, and more effective. Over the past few years, we weathered a series of shocks-including a global pandemic, the repercussions of a military conflict in Europe and a volcanic eruption at home, without serious erosion of economic or financial stability. That, I believe, is a testament to the strength of the framework we have built.

Thank you.