

Ásgeir Jónsson: Speech – 65th Annual Meeting of the Central Bank of Iceland

Speech by Mr Ásgeir Jónsson, Governor of the Central Bank of Iceland, at the 65th Annual Meeting of the Central Bank of Iceland, Reykjavík, 9 April 2026.

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

In February 1995, just over 30 years ago, a newly graduated economist participated in contractual wage negotiations at the State Mediator's office in Reykjavík. The day was broken up with ancillary meetings on special terms of employment for certain groups, but otherwise, those present waited for night to fall, as negotiations did not begin in earnest until after midnight. The economist in attendance published an article about the experience in the business journal *Vísbending* on 19 May 1995. It reads as follows:

"In February, the Icelandic Federation of Labour and Confederation of Icelandic Employers' most recent wage negotiations were held in Reykjavík at the State Mediator's office, referred to colloquially as the Grouse House. The talks took a week and were attended by people from most parts of the country. For seven days, participants groused about wage protection insurance, age-based pay rises, and workplace gloves, but finally, on the eve of the eighth day, the agenda turned to pay increases. Leaders of various types sat down and, over the space of a few hours, set pay rates for some 70,000 workers. It was a simple task, actually, as everyone received the same pay rise, within a range of a few hundred krónur, no matter whether they were employed in fish processing in Reyðarfjörður, in a convenience store in Breiðholt, or at a petrol station in Mosfellsbær. On the morning of the eighth day, the contracts were ready."

To the young economist's way of thinking, this approach was at odds with what he had learned in his textbooks; i.e., that wages should be determined by marginal labour productivity. But the negotiations at the Grouse House in 1995 yielded the same pay rise for everyone.

The young economist was Yours Truly. At the time, I worked as an economist for the Dagsbrún labour union, then under the leadership of Guðmundur J. Guðmundsson. And it was at these interminable nighttime meetings that I finally learned to drink coffee.

It was a difficult winter. Progress had been made in bringing inflation down, but unemployment was rising and measured nearly 7%. Wages were low by all measures, and we were faced with the cold, hard reality that Dagsbrún's pay scales had about the same purchasing power in 1995 as in 1972. Nearly a quarter-century of bitter labour disputes had therefore yielded nothing, and indeed, before the national reconciliation agreement took effect in 1990, strikes had been very common in Iceland. Iceland's labour productivity was among the lowest in Western Europe.

In short, after Iceland's territorial waters were expanded in 1972, its prosperity was ratcheted up with investments in stern trawlers and fish processing plants concurrent with increased cod fishing. This progress soon gave way to overfishing. And after the last large year class for cod was caught in 1986-1987, Icelanders' standard of living deteriorated fairly steadily.

A vociferous group within Dagsbrún wanted to use force to improve their terms of employment. Dagsbrún's president was lambasted with repeated accusations of cowardice. At union meetings, strikes and work stoppages were discussed, but in the end, Dagsbrún joined the others at the Grouse House, where relatively modest pay rises of equal nominal amounts were agreed for all workers represented there. One of my tasks was to persuade Dagsbrún leaders to approve these contracts on that final night. The 1990 national reconciliation agreement was extended for an additional two years.

Honoured guests:

Why has inflation often been high in Iceland? In 1982, the Central Bank's Chief Economist at that time, Bjarni Bragi Jónsson, advanced a theory in the Bank's economic publication *Fjármálatíðindi*, where he posited that inflation stemmed from the lack of a social covenant setting ground rules for interactions between interest groups so as to protect overall interests.¹ The primary objective of wage agreements was to maintain the wage differential between occupations, and because there was no consensus on what that differential should be, contract negotiations devolved into a game of leapfrog in which worker groups took turns demanding "wage corrections". The repercussions of this tug-of-war then surfaced in hefty nominal wage hikes well in excess of the economy's capacity and far out of line with price stability.

In his article, Bjarni Bragi presented two recommendations, which read as follows:

1. Improve the societal covenant; make it more complete and harmonised, with key provisions bound at levels consistent with the overall limits of the economy.
2. Shift the resolution process largely from the social partners to the market and to freer and more diverse private enterprise.

The 1990 national reconciliation agreement were an experiment in constructing a new social covenant centred on economic stability. The covenant was based precisely on the idea that all workers should receive the same pay increases – as I witnessed during the negotiations in the Grouse House. Two unions were opposed to the reconciliation agreement at the time: the Federation of Graduate Public Employees (BHMR) and the Icelandic Air Traffic Controller Association (ICEATCA). The Government responded by passing legislation cancelling wage increases previously negotiated for these two unions, thereby ensuring that all groups received the same pay rises. BHMR members were livid. They erected a *níðstöng*, or voodoo pole, and laid a curse on the Government – perhaps not the most auspicious beginning for a reconciliation. The other labour unions viewed the reconciliation agreement solely as an emergency measure, not as a permanent social covenant.

Icelanders compensated for the lack of social covenant by using indices. Bjarni Bragi Jónsson coined the term *brattgönguajafnvægi*, which could be translated loosely as rock face equilibrium. The term refers to the use of indices to maintain macroeconomic equilibrium on the steep rock face of inflation. It can be said that the indices ensure impartiality, so that inflation does not reallocate resources within the economy, disrupt relative prices, or disturb the real economy.

Under this system, wages were index-linked, thereby ensuring that workers were automatically compensated for inflation. Loan principal and savings account balances were adjusted via indexation. Rental agreements were updated using the consumer price index. Public entities and Government-owned companies linked their fee schedules to indices. In such an index-happy environment, inflation expectations are merely an extrapolation of today's inflation rate.

The continuous use of indices to adjust the price level results in perennial inflation. All shocks – such as oil price hikes – automatically lead to a spiral between wages and prices which then causes the real exchange rate to rise and the nominal exchange rate eventually to fall or be devalued. No one need be too surprised, then, that in the early 1980's, the Central Bank created a special index that Bjarni Bragi Jónsson named the *gengistilefnis vísitala*, which we can perhaps call the exchange rate indicator index. This index measured the need for a currency depreciation based on developments in relative unit labour costs at home and abroad. The króna was then devalued or allowed to depreciate to accord with the index. The monetary policy of this period was in effect a crawling peg.

It can be said that the Icelandic economy scaled a cliff face when inflation surged from just over 6% in 1970 to 43% in 1973 and then remained there. After 1980, a new cliff crawl began with a spiral between wages and prices, alongside a series of currency devaluations, bringing annual inflation to 103% by August 1983. But the new Government led by Steingrímur Hermannsson made the first moves to shed the shackles of the index system by abandoning wage indexation in June 1983. Inflation quickly fell.

Honoured guests:

The national reconciliation agreement of 1990 was underpinned by a fixed exchange rate policy with deviation bands, under which the króna was pegged to a trade-weighted basket of 17 currencies and interest rates were to be used as a policy instrument. The initial results were favourable. In a mere two years after the reconciliation agreement was made, inflation tumbled from 20% in December 1989 to 1.5% in 1992.

The 1995 wage agreements reflected an effort to extend the national reconciliation agreement, but soon afterwards it was *déjà vu* all over again. Between 1997 and 2000, wages in Iceland rose by an average of 8% per year. Private consumption started growing, inflation surged, and by 2000 the current account deficit measured 10% of GDP. The deficit undermined the fixed exchange rate, and the Central Bank raised interest rates to protect the currency. At the beginning of 2001, the Bank's policy interest rate was 11.4%, but it did not suffice. The Bank resorted to selling foreign currency to defend the króna. Soon its international reserves were largely depleted, and

at an historic annual meeting of the Bank in 2001, the Government and the Bank announced the abandonment of the exchange rate peg and the adoption of a floating exchange rate and an inflation target. Soon thereafter, a new Central Bank Act was passed, with the aim of guaranteeing the Bank's independence. The króna depreciated sharply in the period immediately after the regime change.

Thus, today's annual meeting marks the passage of 25 years since Iceland established its inflation targeting regime on the ashes of the old exchange rate peg and enshrined Central Bank independence in law. There was good reason to celebrate. Monetary policy based on a unilaterally fixed exchange rate was in common use around the world in the 1970s and 1980s. The objective was to import credibility and bring inflation down by pegging the local currency exchange rate to a robust global currency such as the Deutsche Mark. It worked at first and for many countries – Iceland included – it remained effective for some time. But in the end, most fixed exchange rate regimes crumbled under pressure from capital movements. This is consistent with what has been called the impossible trinity theory, which states that monetary independence, a fixed exchange rate, and free movement of capital cannot coexist. Nevertheless, it can be said that the fixed exchange rate system, particularly the pegging of the French franc to the Deutsche Mark, laid the foundations for the establishment of the euro in 1999. It is now customary in Europe for countries either to have an inflation target or to have adopted the euro via European Union membership. The exception is Denmark, which for nearly 30 years has chosen to maintain its own currency but peg it to the euro, which is supported by the European Central Bank.

By and large, the conduct of monetary policy is the same in Iceland as in other advanced economies. Furthermore, all metrics show that monetary policy is transmitted effectively to the financial system. Iceland's monetary policy performance has not always been as successful as hoped, however. The main reason for this is that we have not managed to do what Bjarni Bragi Jónsson recommended in 1982 – to put in place an effective social covenant consistent with the 2½% inflation target – so that we as a nation could allocate the available resources among ourselves without creating inflation. Instead, in effect we still have widespread indexation links throughout the economy.

All of our Nordic neighbours have such a covenant, which fosters equilibrium, price stability, and low interest rates. Their covenant is actually independent of the monetary regime each country has chosen for itself. It does not matter fundamentally whether our neighbouring countries have adopted the euro, maintained a fixed exchange rate, or chosen an inflation target. But in Iceland, all attempts to convert national reconciliation to a permanent social covenant have failed. The 2024 wage agreements were supposed to set the stage for such a conversion but unfortunately did not achieve that.

Honoured guests:

In this context, I would like to briefly summarise important elements of economic history over the past five years. It is important to draw the appropriate lessons from past events.

After the onset of the COVID-19 pandemic and Russia's full-scale invasion of Ukraine, inflation spread like wildfire across the Western world. In 2022, inflation was broadly similar in most Western countries, between 8% and 9%. It measured the same in Iceland as in the eurozone, or roughly 8½%. In Europe, wage-earners absorbed the

inflation spike with a reduction in real wages. In Sweden, real wages contracted by 10% between 2021 and 2023, while in Norway and Denmark they also declined. In the eurozone, real wages dropped 7% over the same period. As a result, these countries' central banks did not have to worry about second-round effects from the labour market. They raised interest rates and inflation subsided, and in time, it became possible to lower rates again. Furthermore, inflation in Europe was due largely to hikes in oil and gas prices, which subsequently reversed. In Iceland, however, the situation was different.

The Icelandic Federation of Labour fractured in 2022, and matters relating to contractual agreements were thrown into disarray. Ultimately, a group of labour unions calved off and negotiated short-term wage agreements providing for a 6.75% pay rise upon signing, plus a so-called GDP growth supplement included in the previous contract, making for a total pay hike of 8.8%. Concurrent with this, the idea of national reconciliation was turned on its head when labour market leaders threatened to respond to Central Bank interest rate hikes by demanding more pay rises.

These short-term wage agreements prevented real wages from falling in Iceland, instead fanning the flames of inflation. Inflation shot up above 10% in early 2023, and the Central Bank was forced to raise its key interest rate to 9.25% and hold it there for quite some time. Its strategy was to cool down the real economy by holding the real policy rate between 3% and 4%. Finally, several key labour unions within the Icelandic Federation of Labour banded together in 2024 and negotiated a relatively moderate wage agreement designed to foster disinflation and interest rate cuts. Of course, the volcanic eruptions on Reykjanes peninsula and Grindavík residents' subsequent relocation to other communities in late 2023 put a spanner in the works. Grindavík residents accounted for about 1% of the nation, and naturally, the real estate market was strongly affected by their purchase of new homes, including with Government assistance.

As autumn 2024 advanced, it looked as though the strategy was working. The first Central Bank policy interest rate cut was made in October, and in the months thereafter the Bank cut rates in tandem with the decline in inflation and inflation expectations. But in spring 2025, concerns arose that inflation was becoming entrenched at 4%. The economy continued to cool, but inflation did not fall.

It is now clear that subsequent wage agreements were out of line with the boundaries set in spring 2024, especially in the case of public sector employees. In addition, the old indexation economy has come back to life. The influence of widespread indexation linkages has now turned up in consumer price developments with rises in rents, public levies, and many other prices. Furthermore, wage drift in the general labour market has been used as justification for the payment of supplements to public employees. Moreover, the private sector 4% pay rise that took effect at the start of 2026 appears to have been passed straight through to prices, compounding the effects of poorly timed excise tax hikes at the beginning of the year. This can only be described as a retreat to the past. Inflation took flight again and is now over 5%.

Honoured guests:

As we all know, the war in the Persian Gulf has caused oil and gas prices to rise. Iceland is less directly affected than most other countries, however, as we rely heavily on domestic energy sources. Even so, the oil price shock exposes us to the risk that we will yet again start scaling the inflationary cliff when the oil price hikes start showing in the CPI. The risk is particularly great now, not only because inflation expectations are so poorly anchored to target but also because the spring 2024 wage agreements contain a termination clause that will be triggered if twelve-month inflation exceeds 4.7% on 1 September 2026. This is one of the reasons the Bank's Monetary Policy Committee raised the policy interest rate at its last meeting and, all else being equal, will have to raise it further.

The Bank has broad authorisations to safeguard the economy's resilience against external shocks. These have been used effectively. The Bank also has broad supervisory powers, which it has used to serve the public interest. The Bank has focused on simplifying financial supervision, communicating with supervised entities, and providing them with guidance aimed at promoting a sound and secure financial system. Iceland's international investment position is strong, the Central Bank's international reserves are sizeable, private sector debt is low in historical and international context, public sector debt is lower than in many other countries, and the financial system is robust. The commercial banks have taken advantage of favourable terms in foreign funding markets by refinancing and lengthening their foreign liabilities. Thus, we are well prepared for shocks that might strike the economy.

Tight macroprudential policy has prevented strong housing demand from creating a credit and debt bubble, with the attendant side effects. Furthermore, the strong upswing in the real economy was not amplified in the financial system, as has so often happened in the past. Because of tight monetary policy, a large share of the past few years' sizeable pay rises has been deposited to savings accounts. The current account is broadly in balance, and the króna has been stable. The Icelandic economy is therefore well positioned overall, at a time when storm clouds are gathering abroad.

On the other hand, we have to ask ourselves how long we can maintain macroeconomic stability if wage rises in Iceland continue to exceed those in other countries and are larger than is consistent with stability and the inflation target.

In the past five years, wages have risen by 7% per year, and real disposable income has grown by an annual average of 4.6%. According to figures from Eurostat, wages in Iceland are the highest in Europe and may be the highest in the world. Icelanders are continually travelling. It has become a national pastime to compare the price of various goods with prices abroad – the price of a cup of coffee, for instance. By the same token, they often ask why interest rates in Iceland are higher than in comparison countries. For some reason, Icelanders do not compare their wages with those in foreign countries; in the case of wages, they compare themselves only to one another.

Honoured guests:

Former Central Bank Governor Jóhannes Nordal notes in his autobiography *Lifað með öldinni* [Living with the Century] that many believed that removing two zeros from the króna in 1981 would help bring inflation under control. Clearly, it did not. It is important

that discussions of pegging the króna to the euro or adopting the euro following possible accession to the EU not fall down that rabbit hole. The above-described problems in the Icelandic labour market will not be solved automatically. The EU does not take responsibility for member states' economic affairs. Iceland's economy is and will always be our own responsibility.

Stringent rules apply to the adoption of the euro according to the so-called ERM-II process, where member states must show incontrovertibly that they can maintain macroeconomic stability. I permit myself to doubt that we could adopt the euro without putting a social covenant in place in the labour market. If it should come to pass that Iceland joined the EU and adopted the euro, and then continued its pattern of raising wages more than other countries do, the result would be severe economic hardship and a painful adjustment.

It is therefore vital that we realise that we must solve our uniquely Icelandic inflation problem ourselves, no matter what currency we use as legal tender in Iceland. Perhaps it can be argued that the promise to adopt the euro after joining the EU would create sufficient incentive or generate enough seriousness about the matter that Icelanders would rectify the situation. In any event, it will be a matter of utmost urgency to guarantee discipline and flexibility in the labour market when monetary policy is no longer independent; for instance, by making it possible to lower nominal wages in response to unemployment. But this does not change the fact that the solution to the current problem – rising inflation, high oil prices, and growing unemployment – lies in a joint effort by the Central Bank, the labour market, and the Government.

Honoured guests:

I began my speech today by telling you about my all-nighters in the Grouse House with Dagsbrún in 1995, when the national reconciliation agreements were extended. Not only did I learn to drink coffee while working with Guðmundur J. Guðmundsson – I also learned that ultimately, inflation is a social issue. Monetary policy is always a prerequisite for price stability, but it will be far less costly if the society, government finances, and the labour market support the achievement of that goal. Inflation is not a private matter for economists; it is a welfare issue affecting society as a whole. The Central Bank's high policy interest rate is primarily a reflection of the fact that we lack the social covenant we need to uproot widespread indexation linkages.

This is of particular concern to me at this juncture, given the currently prevailing global situation. High oil prices and other global trade disruptions naturally have a negative impact on the Icelandic economy, in addition to pushing inflation higher. Under these circumstances, the Central Bank has no other option than to respond with interest rate hikes to keep inflation at bay and bring it back to target. I think this is precisely the right time for us as a society to slow down and think and discuss joint actions we can take to maintain stability. We have managed to build up a standard of living that is among the best in the world. That is good. But I would like to close with a line from Gísli saga Súrssonar: He who knows moderation knows all things.

¹ <https://sedlabanki.is/library?itemid=4b8e72cd-cfe1-11e1-958d-001ec9ed9436>