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Presentation by Deputy Governor of Monetary Policy Pórarinn G. Pétursson in a Panel Discussion at the Reykja- vik Economic Conference

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The topic of this panel is *Currencies: Buffers or amplifiers of shocks?* - a topic that is central to the trade-off facing small open economies. The question is whether exchange rate variability helps to absorb shocks or if it amplifies shocks through inflation, balance sheet risks and over-all risk sentiment. The key question is: when does exchange rate variability help and when does it hurt? I think the experience of Iceland over the last few decades captures these trade-offs particularly well.

Let me start at the beginning of the century. Iceland had recently abandoned its exchange rate peg and adopted inflation targeting in 2001, but soon afterwards serious macroeconomic imbalances began to build up. The banking system was privatized in the early years of the century and large capital inflows followed. Macroeconomic imbalances built up, a credit boom ensued and borrowing in foreign currency became widespread among households and firms. The current account deficit ballooned to 25% of GDP. The economy overheated, and then, it all came to a tragic end. There was a sudden stop in capital inflows which resulted in a sharp depreciation of the currency. The vast majority of Iceland's banking system collapsed during the crisis, as all three major banks failed within a matter of days. The depreciation of the krona by almost 50% had a devastating effect on domestic balance sheets. Therefore, one can argue that the krona served as an amplifier of shocks in the pre-GFC period.

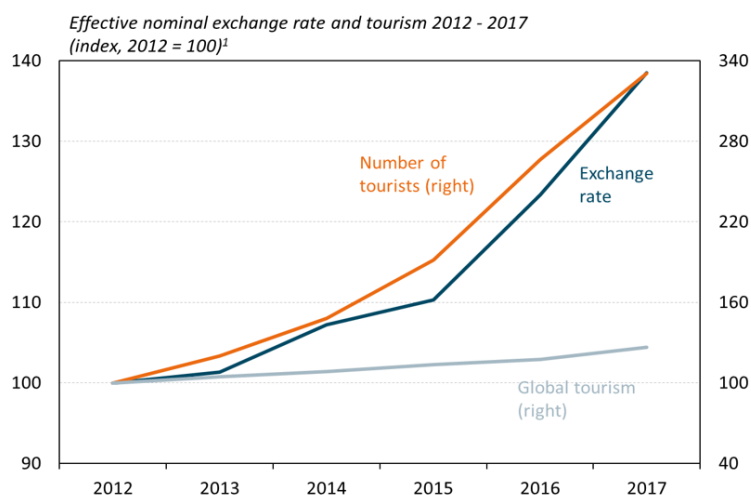
Something changed after the financial crisis. As the saying goes one should never let a good crisis go to waste; the aftermath of a crisis often provides a unique window for reform and Iceland certainly did not miss that opportunity, as the finance minister discussed earlier this morning. The first task was to reduce the large macroeconomic imbalances that had built up prior to the crisis. The current account shifted from a deficit of 25% of GDP to a surplus of roughly 6%. The net international investment position improved from a negative of roughly 150% of GDP to a positive 40%. Foreign currency balance sheet exposure was reduced by limiting households' ability to take foreign currency loans.

Buffers were built up. The Central Bank's foreign exchange reserves increased from a very low level at the height of the financial crisis to around 20% of GDP. Finally, major policy reforms were introduced,

including establishment of a Monetary Policy Committee in 2009 with both internal and external members, and a significant overhaul of monetary policy communication through measures such as publication of minutes and voting records etc. The tool kit of the Central Bank was also expanded, for example through the use of foreign exchange interventions to support the effectiveness of the FX market, and macroprudential measures were introduced, both to lean against the financial cycle and to build up resilience.

As a result, the behaviour of the exchange rate of the krona began to change after the financial crisis. It didn't stop fluctuating, but the fluctuations became more modest and orderly. And in fact, when you compare it to other currencies, like the major currencies and the other floating Nordic kronas, there are no striking differences in the degree of exchange rate variability.

But hang on, you may say, what about the more recent period? What about the sustained appreciation in the early part of the last decade and then the reversal of that by the end of the decade. Let's look at that. First - the appreciation. Now as you may know this country has become a very popular tourist destination, but that wasn't the case at the start of the last decade. Then we had tourist numbers of about 500 thousand per year. Three years later the numbers had risen to one million. By 2017 they had risen to more than 2.2 million arrivals per year. So roughly doubling every 3 years. You can see on the graph, that the expansion of tourism was about 300% over this period which is roughly tenfold of what we see in globally.



This had huge effects on our exports. The service exports expanded by 75% and total exports by roughly 50%. This, what I like to call foreign taste shock, had a huge impact on our exchange rate. Basically Iceland's relative wealth increased and pushed up our equilibrium real exchange rate and the nominal rate appreciated by roughly 35%.

So, I would argue that this is a case of a currency doing the job that it is supposed to do. There was a positive external shock and the krona appreciated, thus crowding out other exports to create space for this newly fast-expanding export industry, but also by shifting some of this newly found wealth towards foreign demand. And I would argue, if the currency had not appreciated, the adjustment to this shock would have been much more challenging.

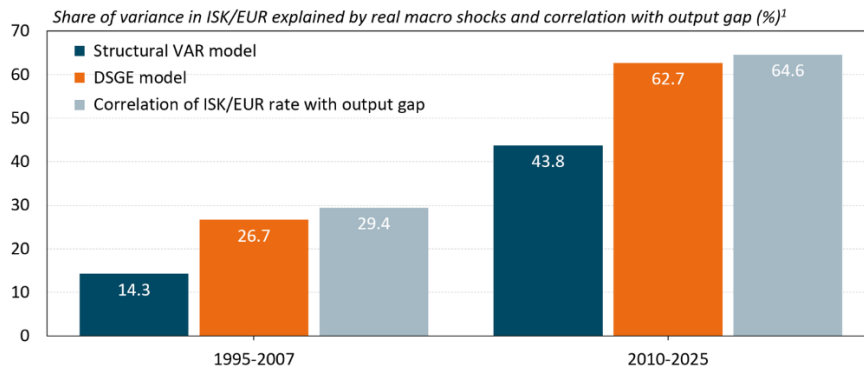
What about the second part? The depreciation part? Well in fact the krona had started to depreciate by late 2018, mainly due to the collapse of the second largest airline in the country, that had a market share of about 30% prior to its collapse, which created a negative shock to the tourism industry and exports, and the krona depreciated.

But the big story is the global pandemic. The pandemic was obviously a global shock, but the impact on Iceland was larger than on other advanced economies. GDP fell by 6.5%. Slightly more than in the euro area, but much more than in our main trading partners and the other Nordic countries that had a contraction of roughly 1.5-2.5%. But the difference becomes much sharper when comparing the impact on exports. Exports in Iceland fell by 30%, which is significantly larger than in other popular tourist destinations in Europe. And much larger than in the other Nordics, with the contraction here about five times larger than in Denmark and Sweden and more than 12 times larger than in Norway. So, exports fell in the first half of 2020 by roughly 50%, and the krona depreciated by roughly 10%. Again, I will argue that this is a case of a currency doing its job. Without the adjustment of the currency, the adjustment to this negative shock would have been larger and the recovery from the shock would have been more challenging.

Now these are largely descriptive observations, so what does the empirical evidence tell us?

Here we have two different variance decompositions to identify nominal and real shocks that drive the EUR/ISK exchange rate – the first using a structural VAR-model with long-run restrictions and the second using structural shocks from the Bank's DSGE model. Both models broadly tell the same story. Prior to the GFC, fluctuations in the krona were dominated by nominal shocks. This changed after the crisis. Now, roughly one-half to two-thirds of krona exchange rate variation reflects real demand and real supply shocks.

Finally, the Figure reports the simple correlation between the EUR/ISK exchange rate and the output gap. This correlation has increased significantly, from around 30% before the GFC to approximately 65% in the post GFC period. In other words, the krona has tended to appreciate during cyclical upswings, but this relationship has become much stronger in the post-crisis period.



¹ For the VAR model the figure shows the variance decomposition of 5-year ahead forecast errors for the nominal ISK/EUR exchange rate from a 3-variable VAR using long-run restrictions based on the identification structure from a simple Mundell-Fleming model (see Clarida and Gali, 1994). The model includes real GDP, real government spending (to identify demand shocks, as in Canzoneri, Valle and Vinals, 1996) and the nominal exchange rate of ISK against the euro. Both real variables are seasonally-adjusted and measured relative to the euro area. The VAR model includes 4 lags and is estimated for the periods Q3/1995-2007/Q4 and Q3/2010:Q1-Q4/2025, respectively. Real macro shocks are the sum of supply and demand shocks. Supply shocks are shocks that have long-run effects on all three variables, while demand shocks only affect domestic absorption and the exchange rate in the long-run, and nominal shocks only affect the exchange rate in the long run. Data from Eurostat (including euro area data prior to 1999), Statistics Iceland and Central Bank of Iceland. For the DSGE model the figure shows the variance decomposition of shocks from the Bank's DSGE model, DYNIMO. Real shocks are all the structural shocks in the model, except domestic and foreign nominal shocks and exchange rate risk premium shocks.
Sources: Own calculations, Central Bank of Iceland.

So, to conclude, prior to the GFC the krona appears to have served much more as a shock amplifier, whereas after the GFC it appears to be doing a far better job of acting as a shock absorber. Why? As I have argued, Iceland has now much stronger macroeconomic fundamentals than before the crisis, significantly lower foreign exchange balance sheet exposure, and stronger policy frameworks with greater credibility.

That said, managing such a small currency will always present challenges for a central bank, and we should not lose sight of that fact.

Thank you.