10 lessons from Icelandic monetary history

Monetary policy over the past few decades shall be assessed to the extent that this has not been done previously, such as in the Central Bank's 2012 report entitled "Iceland's currency and exchange rate policy options."

An in-depth comparison shall be carried out of the advantages and disadvantages of monetary policy frameworks according to Items 2 and 3, as regards the contribution of monetary policy, in concert with other economic policies, to economic and financial stability.

One hundred years of solitude

In Iceland's campaign for independence, currency issues were never mentioned. It was automatically assumed that Iceland would remain in a currency union with the Nordic countries as an independent entity — as the Norwegians had done when they separated from Sweden in 1905. Participation in Nordic Currency Union was actually written into the agreement made when Iceland was granted sovereignty in 1918. This currency cooperation was based on the gold standard, as most of the world's currencies did at that time.

Icelanders woke up as from a bad dream, however, after the war ended. Not only had the currency cooperation among the other Nordic countries disintegrated, but Iceland began its life as a sovereign nation by becoming insolvent. During the war, inflation ran amok, with the associated rise in the real exchange rate and imports, and afterwards, marine product prices fell, and the products themselves became difficult to sell. Actually, this appears to have taken everyone by surprise. In summer 1920, officials at the Icelandic Treasury tried to cash a mail order cheque from Íslandsbanki (then functioning as the country's central bank) in Copenhagen. The cheque bounced. Over the next winter, it proved necessary to ration necessities in Iceland because of a currency shortage, until efforts to sell marine products bore fruit and a loan from Britain could be negotiated.

Ever since the rubber check bounced in Copenhagen in 1920, there has been vociferous discussion of exchange rate and monetary policy issues in Iceland — committees have been appointed, foreign experts have been hired to write opinions, and the topics have been hotly debated from the chambers of Parliament to cafés and kitchens all over the country. And we are still at it.

Over the 100 years of Iceland's sovereignty and full control of its own monetary affairs, a number of things have been tried. Icelanders have been in a currency union, used the gold standard, and tried a fixed exchange rate with capital controls and an exchange rate peg within the Bretton Woods system. Experiments have been done with money supply targeting, real exchange rate targeting, and a fixed exchange rate with shadow membership of the European Monetary System (EMS). Icelanders have also tried an inflation target with a free-floating exchange rate and now, since 2009, a flexible inflation target supported by capital controls. In the following summary, an attempt has been made to discuss each of these policies — how they have turned out and what has gone amiss with their implementation. The world has changed — Iceland has changed — over these 100 years, yet nevertheless, the economic principles are the same, and the same themes always reappear when it comes to monetary policy conduct. As a result, it should not be inappropriate to try to learn some lessons from the experiments that we have undertaken to date.

In the view of the authors, the following 10 lessons can be learned from Iceland's 100-year monetary history.

Lesson 1 – Following the rules of the game is more important than which game is selected

All currency frameworks have their pros and cons, which have been discussed in innumerable reports through the years. On the other hand, much less has been said about the ground rules for each framework. The fact is, however, that it is not of principal importance *which* framework is chosen; what is more important is to follow the ground rules required by each framework at any given time. The reason Icelanders have generally lived with instability and inflation since becoming a sovereign nation is not that they have always chosen the wrong monetary policy framework, or that they have not yet found the one that best suits them. The reason is that they have not followed the ground rules required by each framework — neither as regards application of economic policy instruments nor as regards maintaining general economic stability. Because of this, each monetary policy framework that has been in effect has disintegrated, and the nation has been forced to tolerate persistent instability and the highest known interest rates in the Western world.

Iceland is not unique in this regard, however. Other countries have also found it difficult to abide by the rules of the game. For example, the gold standard was abandoned because the ground rules accompanying it — such as that inflation should be corrected with deflation — proved too costly in execution and became politically infeasible as the twentieth century advanced. The same applies to the Bretton Woods fixed exchange rate system, which collapsed because the United States no longer wanted to follow the rules. Other countries also lost control of inflation after the fall of Bretton Woods in 1971-1973, as Iceland did. The same happened within the European Monetary Union. Many member countries, particularly in the Mediterranean region, have been unable to follow the ground rules demanded by a common currency, and this has led to economic crisis. On the other hand, Iceland's deviation from the rules has been much more pronounced than that in other countries — it is as though the country has not really even tried to follow the rules required by monetary policy at any given time. Unfortunately, Iceland itself has borne the brunt of this.

Lesson 2 – Economic policy needs political support

In the 1920s, a new system of political parties emerged based on class struggle, one comprising four main parties. For some reason, conventional economic policy, which is based on applying monetary and fiscal policy instruments so as to mitigate cyclical volatility, has never gained a foothold in this "new" system. Other political goals — employment issues, social welfare issues, regional policy, or simply the desire to win the next elections — have always taken priority over the task of maintaining economic stability. This can be seen in the fact that the country's central bank did not have the political authorisation to apply the policy interest rate until the beginning of the twenty-first century. It can also be seen in the fact that fiscal policy has not been applied so as to maintain stability; for example, by curbing spending during boom times.

This political assessment of interests is at odds with the interests of the nation, however, as the social cost associated with not applying these instruments appropriately is enormous. This cost showed in the imposition of broad-based capital controls in 1931-1960, in runaway inflation in 1971-1989, and in the turmoil of 2001 and 2008. Developments in recent years cast substantial doubt on whether the fiscal budget and Government actions, as well as the actions taken by Government institutions, have given sufficient consideration to the inflation target. The Central Bank has generally stood virtually alone and unsupported in its fight against inflation, although the new Act on Public Finances has improved matters in the past few years.

Iceland is a democratic country, and its elected representatives reflect the voters' choices. The problem lies not in individual persons or political parties but in the type of democratic culture Icelanders have adopted. Perhaps this is also a question of democratic knowledge: whether voters understand cause-and-effect relationships as they apply to economic affairs. It is clear, however, that no monetary policy in a democratic country will be successful — at least not in the long run — without broad-based political support.

Lesson 3 – Stability in the labour market is the cornerstone of price stability

A strike undertaken by eight labour unions on 2 January 1941 was a historical watershed. After that date, nominal wages generally rose much faster than can be considered consistent with appropriate real wage growth. Real wage growth stems from productivity — how much increased value is generated by each hour worked. Underpinning productivity are technological advancements, improved education, and strong social foundations. In the long run, productivity can be expected to grow by 1-2% per year, and that is exactly the rate at which real wages have grown, on average. Nominal wage rises in excess of this deliver only inflation.

In such a small, open economy as Iceland's, where a large share of consumer goods are imported, it is possible to achieve additional real wage growth if terms of trade and exports develop very favourably. In addition, nominal wage rises in excess of productivity can generate purchasing power that stems from a higher real exchange rate and lower import prices. These benefits are generally short-lived — and they generally reverse. Wage rises in excess of productivity are bound to erode Iceland's competitive position and cut into exports, while simultaneously encouraging imports. The result is a current account deficit that must be financed by borrowing abroad, but this can only be done for a limited time. Sooner or later, a current account deficit will push the country into insolvency unless the real exchange rate is corrected with a currency devaluation, which generally causes inflation and brings purchasing power back down to a realistic level.

In 1980, Jónas Haralz, then a director of Landsbanki Íslands, delivered a lecture to the Association of Business Specialists and Economists on the reasons why Iceland was such a high-inflation country. In his view, Iceland's inflation stemmed from two main causes: on the one hand, fluctuations in fishing, which called for regular currency devaluations, and on the other, disputes about the division of the nation's "spoils", with inflation as a sort of "arbitrated ruling in a societal tug-of-war". Jónas was referring to the long-standing objective of wage agreements, which had been to maintain the wage differential between occupational groups. And because the groups themselves were generally not in agreement about what that differential should be, wage agreements would become a game of leap frog, with each group in turn arguing for a "correction of wages." The repercussions of this tug-of-war showed in steep nominal wage rises well in excess the economy's capacity to pay — which the economy then had to mitigate through inflation and a decline in real wages, often after a significant drop in the exchange rate.[1]

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[1]This lecture was later published as a chapter entitled *Í ljósi reynslunnar (In view of experience)* in a compendium of Jónas' work entitled *Velferðaríki á villigötum (A welfare state on the wrong path)*. Jónas H. Haralz. (1981). *Velferðarríki á villigötum: úrval greina frá áttunda áratugnum. (A welfare state on the wrong path: a selection of papers from the 1970s).* Reykjavík: Félag frjálshyggjumanna.

If Jónas Haralz was right, it is the tension between classes or occupational groups that is the root cause of inflation, as the fact is that Icelanders do not agree on what the wage differential should be between various groups in society: between labourers and university-educated employees, between flight attendants and land-based service employees, between teachers and people in retail or wholesale trade, between members of Parliament and disability pensioners, between the Bishop of Iceland and regular wage-earners. There is no consensus on this in Iceland, unlike the situation in other Nordic countries.

The fact is that the wage gap is generally rather small in Iceland compared to that abroad. It is also true that the lowest pay scales in Iceland have risen much more than the wages of the middle-class in recent years. Third, it is true that remuneration for education is much less in Iceland than elsewhere in the OECD, especially in terms of disposable income. And finally, it is a fact that the low inflation in Iceland since 2014 has delivered enormous benefits to Icelandic wage-earners in the form of increased purchasing power — because large nominal pay hikes have not triggered a surge in inflation. Nevertheless, class unrest appears to be on the rise in Iceland, and it could easily lead to economic instability, as it has done so often before.

A simple rule of thumb indicates that, with a 2.5% inflation target and 1-2% productivity growth, nominal wages may not rise more than 3,5-4.5% per year in the long run without destabilising policy. Over the past five years, nominal wage rises have measured 8% per year. This is not sustainable. Actually, no monetary policy framework will be successful in Iceland as long as this class unrest causes nominal wages to rise at the pace seen in recent years and decades. Iceland can only ensure low inflation in the long run if there is some sort of consensus among wage-earner groups on wage decisions — because labour market stability is the cornerstone of price stability.

Lesson 4 – Icelanders long for a stable exchange rate but do not have the tenacity required

Reviewing Iceland's currency history shows clearly that Icelanders have generally preferred a fixed exchange rate. To this end, they have participated directly or indirectly in the pegged exchange rate regimes on offer at any given time in Western Europe: the Nordic currency union, the gold standard, Bretton Woods, or the EMS — until the creation of the euro in 1998. The roots of this desire probably lie in the extreme impact that exchange rate movements have on the entire economy, where as soon as the króna begins to move, funds are shifted between sectors, between consumers and companies, between creditors and debtors, and so forth. Of course, it is abundantly clear that such exchange rate movements can serve a positive economic purpose if they are aligned with the business cycle position. Furthermore, a flexible exchange rate can provide a cushion against the impact of changes in export revenues on the general economy. The rise in the exchange rate of the króna in the recent term is not in and of itself abnormal, given the boom in tourism. Nevertheless, businesses and the general public are discomfited by these movements.

The Danes' opinion on currency matters resembles that of Icelanders, in that they have had a unilateral pegged exchange rate since 1981. This peg has been successful because the Danish nation is aware of the ground rules that this entails, and there is broad-based agreement in Danish society that economic policy should be conducted in accordance with it. There is also a widespread understanding that wages in Denmark cannot rise in excess of wages in the countries to which the peg extends; they are corrected with productivity. If such a thing happens, the real exchange rate will rise and erode the competitive position, which will ultimately surface in a current account deficit that will derail the fixed exchange rate regime.

To be sure, a fixed exchange rate is more difficult to pursue in Iceland than in Denmark, as Iceland's exports are less diverse. Iceland is an island, and it does not have the same economic connections to any single currency, unlike Denmark, which is contiguous with Germany. It is also true that the credibility of Denmark's pegged exchange rate regime is guaranteed to an extent by the backing of the European Central Bank. On the other hand, it has been an oft-repeated refrain throughout Iceland's history as a sovereign state that Icelanders have not had the patience needed to achieve their goal of maintaining a fixed exchange rate. Unlike the Danes, Icelanders have been unable to maintain the economic policy needed to sustain a fixed exchange rate. As a result, they have often resorted to the time-honoured Icelandic response of patching up their fixed exchange rate policy with capital controls. The one exception to this is the beginning of the fixed exchange rate regime in 1989, which was supported by a broad-based consensus in the labour market — known as national reconciliation — but over time, economic policy grew looser and looser, and nominal wage rises took off again, resulting in the collapse of the exchange rate regime in 2001.

Actually, every single upswing since World War II has ended in economic overheating and steep wage cost increases for the economy, which have then been compensated for with currency depreciation and inflation. In this context, it is worth noting that even though the exchange rate collapse in 2008 cannot be considered anything but an adjustment following the overexpansion and outsized current account deficit of the years preceding, in public discourse it was labelled a case of breached premises. This breach appeared to be viewed as a mixture of accident and conspiracy that had to be "corrected" with the payment of benefits. In this way, the nation appears now, as before, to be demanding a fixed exchange rate.

A fixed exchange rate is only possible through the pursuit of new economic policy practices — particularly to include fiscal policy and wage-setting in the labour market — because it will be extremely painful for the economy to regain its competitiveness through nominal pay cuts. Perhaps Icelanders can change their ways and adopt increased discipline, as they did to a degree in the 1920s, when the objective was to participate in the international gold standard, or in the 1960s, when Iceland was a full participant in Bretton Woods. The question arises whether this is actually feasible. Apart from this, it is clear that the demand will generally be made that long-term monetary policy entail exchange rate stability.

Lesson 5 – The balance of payments is the axle of Icelandic economic policy

Surveying Iceland's economic history from sovereignty to the present shows that developments in the balance of payments have been the axle of Icelandic economic policy. The balance of payments is the sum of the current account balance and the capital account balance, which by definition is always zero. Iceland's balance of payments has been very volatile for two reasons. First of all, it is because of how homogeneous Iceland's exports have been, with one export sector generally driving the economy at any given time. Early on, the fishing industry was the dominant sector, then financial services, and now it is tourism. In Iceland's history it has often happened that export revenues have dropped because of factors such as a decline in marine product prices or a catch failure, and the country has been faced with a current account deficit. The second reason for this volatility is the fact that growth in domestic demand always shows in strong imports, owing to the country's small size. The impact will be even stronger if this surge in demand leads to overheating, inflation, and pay hikes, which is such a classic pattern in Iceland. Another result of this is a current account deficit. These two factors — fluctuations in exports and an unwillingness to apply conventional economic policy instruments — have led to a persistent balance of payments problem. A current account deficit must be financed either with foreign borrowings or with currency sales from the foreign exchange reserves; otherwise, the exchange rate is bound to fall so that export revenues and import purchases will balance. If it is not possible to borrow abroad but the exchange rate is held constant, the only outcome can be the prospect of insolvency, as happened in 1920, 1931, and 1945 — to which the response was to impose restrictions on imports and/or to ration foreign consumer goods.

This balance of payments problem has only grown in recent years, following liberalisation of capital transactions and increased global capital flows. The downside of importing capital is that it often leads to expansion and asset bubbles — and a large current account deficit. The effects are not entirely symmetric, however. Imbalances build up gradually, alongside strong inflows, but frequently the adjustment takes an extreme form: a sudden stop in capital inflows, as occurred in the winter of 2000/2001, or large-scale outflows of liquidity, as occurred in the autumn of 2008. Concurrent with this, tourism has taken over from the fishing industry as the leader in export revenue generation, but it is subject to the same risks. It is not difficult to foresee a downturn in the sale of trips to Iceland in the wake of changes in the global economy, as has often happened in the fishing industry.

Iceland's unstable balance of payments creates a significant problem for Icelandic monetary policy, as the wide interest rate differential with abroad attracts foreign venture capital and upsets the balance of the economy, as it did in 2004-2008. In 2001, a 20-30% depreciation of the króna sufficed to turn the current account deficit into a surplus and normalise the foreign exchange market. In 2008, a 50% depreciation was not enough, as foreign currency speculators had such large positions (about ISK 650 bn) in the Icelandic financial system. As a result, Iceland was actually insolvent. Imposing capital controls was therefore a last-resort solution at that time.

In her paper *Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence,* Hélène Rey argued that independent monetary policy was actually impossible if global capital movements were unrestricted: " ... independent monetary policies are possible if and only if the capital account is managed, directly or indirectly, regardless of the exchange-rate regime."[2]

It is abundantly clear that the Central Bank must be manage developments in the balance of payments in order to be able to ensure price stability and economic stability — and implement its monetary policy. The Bank can do this in three ways. First of all, it can impose restrictions on inflows, with the aim of preventing foreign bond investors from pushing the exchange rate of the króna above its equilibrium rate and building up large foreign exchange positions, as they did before the crisis. This method can only be applied temporarily, however, as capital controls are in contravention of the EEA Agreement provisions on free movement of capital. The second way is to use the foreign exchange reserves (currently about ISK 650 bn) to prevent disturbances in the foreign exchange market. The third method is to use macroprudential tools to impose limitations on debt and credit creation in the financial system that could otherwise jeopardise the balance of payments. Perhaps this can be viewed as a re-design of the policy the Central Bank followed in earlier years with the use of reserve requirements.

This is always a balancing act, particularly as regards coordination with conventional monetary policy as entailed in setting the policy rate. Furthermore, it is necessary to find ways to achieve this without

[2] Fluctuating exchange rates cannot insulate economies from the global financial cycle, when capital is mobile. The "trilemma morphs into a "dilemma" – independent monetary policies are possible if and only if the capital account is managed, directly or indirectly, regardless of the exchange-rate regime. Hélène Rey. (2018). *Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence.* Accessed at http://www.nber.org/papers/w21162

imposing capital controls, which bring with them considerable economic cost. But therein lies the actual guarantee of stability for the future.

Lesson 6 – Financial stability must be the Central Bank's second objective

On 21 September 2009, the Dutch central bank held a symposium bearing the title *Towards a new framework for monetary policy? Lessons from the crisis.*[3] In an address entitled *Flexible Inflation Targeting: Lessons from the Financial Crisis,* delivered at that symposium, Lars Svensson, then-current deputy governor of the Swedish central bank, maintained that inflation targeting in action must take the form of what he called "flexible inflation targeting," featuring a balance between the price stability objective and resource utilisation that could be called "well balanced" monetary policy. Financial stability in and of itself could never be one of the objectives of monetary policy, but must put constraints on it.[4]

It is possible to place Icelandic monetary policy during the period 2004-2008 into context with this address by Svensson: at that time, Iceland had an enormous interest rate differential with abroad, a 20-30% current account deficit financed with foreign debt by resident borrowers fleeing Icelandic interest rates, and position-taking by non-residents seeking to benefit from Icelandic interest rates. The task entrusted to monetary policy at that time was actually unmanageable. Attempts to achieve the legally mandated price stability objective with the policy rate as the sole weapon in its arsenal caused monetary policy to step outside the boundaries Svensson mentions above and to undermine financial stability. It could well be that the Icelandic banks would have failed irrespective of which monetary policy regime had been in place, because they did not have a credible lender of last resort. On the other hand, the cost of the collapse was much greater than it would have been otherwise because of the severe balance of payments disequilibrium that had developed during the years beforehand. This caused foreign exchange risk to escalate out of control. The aftereffects entailed enormous private sector debt problems resulting from exchange rate-linked loans and the difficulty of releasing the ISK 650 bn carry trade-related "overhang" that was stranded within the Icelandic financial system after the capital controls were introduced in November 2008. Fortunately, much of this cost could be shifted over to foreign creditors or the speculators themselves.

Financial stability generally refers to the assumption that financial markets can carry out their role as markets, by distributing capital and risk in the economy and ensuring secure payments. It therefore carries great significance for a small, open economy because of the interactions between the financial system and foreign exchange transactions. The reason is simple: When there are net outflows, money flows from accounts with financial institutions via the foreign exchange market. Financial instability in small, open economies therefore requires that monetary policy must be applied counter to the business cycle in order to respond to capital flight and a steep drop in the exchange rate. As a result, it is necessary to raise interest rates substantially and cut back on Government spending to normalise the balance of payments, even though the economy is headed for a crisis. This is what the countries in

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[3] Nout Wellink, Lars Svensson, Marvin Goodfriend, Stephen Roach, Claudio Borio, Charles Goodhart, and Lex Hoogduin. Workshop *Towards a new framework for monetary policy? Lessons from the crisis.* De Nederlandsche Bank. (Accessed at https://www.dnb.nl/en/interest-rates-and-inflation/monetary-policy/workshop-on-otowards-a-new-framework-for-monetary-policy-lessons-from-the-crisis/index.jsp)

[4] "One question is whether financial stability belongs in the loss function for the central bank, together with inflation and resource utilization. I argued that a good way of handling this additional objective is as a constraint on monetary policy rather than as a separate target variable that appears in the loss function." Lars E.O. Svensson. (2009). *Flexible Inflation Targeting: Lessons from the Financial Crisis*. Sveriges Riksbank. Accessed at http://archive.riksbank.se/Upload/Dokument_riksbank/Kat_publicerat/Tal/2009/090921e.pdf

Southeast Asia were forced to do, for example, after they sought assistance from the IMF during the so-called Asian crisis of 1998. These measures were extremely painful and controversial at the time, but they worked well. The economic downturn was relatively brief, and Asian economies retained their integration with global financial markets. Iceland avoided some of this unpleasantness by imposing capital controls with the approval of the IMF, which considered itself to have learned from the experience of the Asian crisis in 1998. Perhaps it made a difference that in 2008, Iceland was the first developed country to seek assistance from the IMF in about three decades, and the Fund was therefore determined to show that it would handle matters with moderation — that Icelanders would not be forced into a cold shower, as the Asian countries had been previously.

After the Icelandic financial crisis, an important change was implemented with the addition of financial stability to the Central Bank Act in 2013 as the Bank's second objective. It is now clear that the application of monetary policy henceforth will have to take account of financial stability, which will place constraints on it — such as how large the interest rate differential with abroad can be without resorting to new capital controls.

Lesson 7 – Macroprudential policy is the foundation of monetary policy for the future

The Central Bank became an independent institution in 1961, but independent policy rate setting was not included at the time. Actually, it can be said that the Bank's independence diminished in this respect when the so-called fifteen-member Landsbanki Committee was disbanded. That committee had been designed to maintain distance from the Government and Parliament. The Bank was nevertheless required to ensure a fixed exchange rate within the Bretton Woods system, and it adopted reserve requirements to ensure balance of payments equilibrium. Under these reserve requirements, the commercial banks had to place 18-27% of their deposits with the Central Bank. This enabled the Bank to control credit creation in the banking system and manage developments in the money supply, which then showed in general demand and imports. This appears to have been fairly successful. There was reasonable stability during this period despite a surge in herring catches and an overall upswing. On the other hand, the Bank's power was subsequently taken away, and the Bank was forced to loan out the capital it had received in the form of reserve requirements through the fisheries' start-up lending scheme. This turned out to be one of the reasons inflation skyrocketed in the 1970s.

It has often been said that the Great Depression begat macroeconomics as a separate field within economics, in part because of John Maynard Keynes' book *The General Theory of Employment, Interest and Money,* published in 1936. In the same manner, the Great Financial Crisis has given rise to macroprudential policy as a separate field within economics and a hot topic of discussion in the discipline. This new field is still relatively loosely defined, as there is not yet a single manifesto like that presented by Keynes for macroeconomics. Macroprudential policy aims to maintain financial stability, which is difficult to quantify, unlike price stability. Macroprudential tools also cover a relatively broad area that overlaps both with conventional monetary policy — for example, where capital controls belong is debated — and with financial market rules. It can be said that this new field is still evolving, and work is now being done to develop the same type of framework for it as is currently in place for conventional monetary policy.[5] More detailed discussion can be found in the report written by Kristin Forbes for the task force on monetary policy review: *Macroprudential Policy after the Crisis: Forging a Thor's Hammer for Financial Stability in Iceland.*

[5] Cecilia Skingsley. (2016). *Objective-setting and communication of macroprudential policies*. Bank for International Settlements. Accessed at https://www.bis.org/publ/cgfs57.pdf

The application of macroprudential tools centres not only on maintaining financial stability, however; this new way of thinking and/or methodology can also hone monetary policy by, for example, curbing financial institutions' lending and affecting developments in the money supply, as was done with reserve requirements in an earlier time. As is stated clearly in Kristin Forbes' report and the above-cited paper by Hélène Rey, the problems associated with free movement of capital are not limited to foreign exchange market instability. They also lie in the fact that global capital flows into the financial systems of the countries concerned, causing credit and asset price bubbles that subsequently derail the economy, as was the case in Iceland in 1998-2000 and again in 2004-2008. The application of macroprudential policy centres on blunting the impact of foreign capital flows on individual financial systems and shifting the transmission of monetary policy into the economy through the credit channel.

It is also the case that interest rates are not a particularly effective tool to combat financial bubbles. Actually, raising interest rates exacerbates the problems associated with asymmetric information, adverse incentives, or adverse selection. But as the interest rate level rises, "regular" investors interested in financing "regular" production withdraw from the market. They are replaced by risk-seeking speculators who want to profit on rising asset prices and are not deterred by the prospect of borrowing at high interest rates, as an asset bubble always entails enormous profit until it finally bursts. It has been said that an interest rate level that would suffice to curb an asset bubble would be so high that it would paralyse the real economy and therefore be enormously costly.[6] By the same token, such a steep rise in interest rates would cause severe problems in the foreign exchange market, with an overly high real exchange rate and a current account deficit, which would certainly undermine financial stability.[7] This should sound familiar to Icelanders who remember the pre-crisis period. Perhaps, then, it is no surprise that Hélène Rey should go so far in her paper is to say that the use of macroprudential tools is one of the prerequisites for countries to be able to pursue independent monetary policy.[8]

But applying macroeconomic policy is no simple matter. There is little doubt that this newly emerged field will become a pillar of the discipline in the future, but at this point there is little experience of it. For example, applying reserve requirements in the old way is probably not beneficial, given the complex liquidity rules with which modern commercial banks must comply. The Central Bank tried, for instance, to raise the required reserve ratio in October 2015 but reversed the decision two months later, as it dried up the banks' liquidity virtually overnight. On the other hand, it is clear that macroprudential policy is the area that currently offers the greatest potential to improve Icelandic monetary policy, no matter what may happen in the future.

Lesson 8 – Controls erode well-being

In 1843, Jón Sigurðsson (the leader of the movement for Iceland´s independence) published an article in the third volume of *Ný félagsrit (New Social Writings)* under the title *Um verslun á Íslandi (On trade in Iceland).* This is without doubt one of the most influential articles ever written in the Icelandic language, as it outlines a new political policy for Iceland, with principal emphasis on free trade in the spirit of Adam Smith. He says in the introduction that the Danish trade monopoly had caused Icelanders

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[6] Avinash D. Persaud. (2009). *The Role of Policy and Banking Supervision in the Light of the Credit Crisis.* Accessed at https://academiccommons.columbia.edu/catalog/ac:130761 and Frank Smets. (2014). *Financial Stability and Monetary Policy: How Closely Interlinked?* European Central Bank. Accessed at http://www.ijcb.org/journal/ijcb14q2a11.htm

[7] Philip Turner. (2017). *Did Central Banks Cause The Last Financial Crisis? Will They Cause The Next?* Institute of Economic and Social Research. Accessed at https://www.niesr.ac.uk/publications/did-central-banks-cause-last-financial-crisis-will-they-cause-next

[8] Hélène Rey. (2018). *Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence.* Accessed at http://www.nber.org/papers/w21162

to “lose the confidence in themselves that is necessary to all, and with it the solidarity and the willingness to help themselves; they have lost the global will for all industry and become cottagers ...” In Jón’s opinion, free trade was the prerequisite for national freedom: his countrymen should seek out international markets and not close themselves off from them. Because of his campaign, the remnants of the Danish trade monopoly (which stipulated that only subjects of the Danish state were permitted to trade in Iceland) were abolished in 1855. Later, Jón presented a retroactive invoice to the Danes and demanded that they reimburse the profit they had made on the trade monopoly. It is somewhat paradoxical that as soon as Icelanders had rid themselves of the shackles of Danish rule, one of the first things they did was to bind export trade down with homemade fetters.

As has been described here, it was persistent balance of payments problems that pushed Icelanders further out onto the thin ice of capital controls and Government intervention in the economy in 1930-1960. And it was not until 1994, when Iceland joined the European Economic Area, that these homemade fetters were loosened entirely. The adoption of capital controls does not necessarily involve blocking capital transactions, however; transactions continue and the relationship between foreign trade and the capital account remains unchanged. On the other hand, the controls politicise capital transactions, since capital transfers are either subject to a politically determined exemption process or are undertaken by the state itself. The politicisation of capital transactions also tends to result in intervention in how the capital is utilised within the country. Thus investments become determined in the political arena rather than on the free market, which generally leads to misallocation of capital. Someone should follow in Jón Sigurðsson’s path and prepare an invoice for the impact the capital controls have had on the country, but the worst part is that the only place to send it would be to Icelanders themselves.

The imposition of the capital controls in 2008 was an emergency measure, and it could be argued that it was necessary during the reconstruction phase.[9] But that work is now done, and the fact remains that, as Jón maintained, capital controls turn Icelanders into “cottagers”, in addition to being financially costly. But at the same time, it can be argued convincingly that it is unacceptable to permit utterly unrestricted movement of global hot money through the foreign exchange market or the financial system, and that such movements should be restricted with macroprudential rules of various types. To reference Hélène Rey again, the effectiveness of monetary policy depends on managing the capital account. On the other hand, global integration of the Icelandic capital market brings enormous benefits. Not only does global capital trade deliver lower long-term interest rates for Icelanders, but it also provides necessary risk diversification in many areas. An example of this is Iceland’s large pension system, with assets totalling ISK 3,900 bn, only one-fourth of which is invested abroad. It would be best if that foreign ratio were closer to 50%.[10] The solution is clearly that the pension funds should invest abroad, and in their place, foreign investors will enter into long-term obligations in Iceland.

Capital controls can be particularly harmful to small markets, as they discriminate between investors by nationality and thereby lead to reduced turnover and a more homogeneous group of market agents. This, in turn, causes uneven price formation and creates an oligopoly in the capital market, as domestic

9 For further discussion, see Ásgeir Jónsson and Hersir Sigurgeirsson. The Icelandic Financial Crisis: A Study into the World´s Smallest Currency Area and its Recovery from Total Banking Collapse.

10 Ásgeir Jónsson and Hersir Sigurgeirsson. (2014). Áhættudreifing eða einangrun? Um tengsl lífeyrissparnaðar, greiðslujafnaðar og erlendra fjárfestinga (Diversification of risk or isolation? The relationship between pension savings, the balance of payments and foreign investment). Accessed at http://audfraedi.is/utgefin-rit/frett/2015/04/27/Ahaettudreifing/, or Friðrik Már Baldursson and Richard Portes (2018). Restoring trust in Iceland: Iceland‘s IMF programme, in Thröstur Olaf Sigurjónsson, Murray Bryant, and David Schwarzkopf (eds.), The Return of Trust? Institutions and the Public after the Icelandic Financial Crisis, pp. 111-127, Emerald Publishing.

financial institutions are the only participants. The result is wider credit spreads. In the small, thin Icelandic capital market, competition issues must be taken seriously, as three commercial banks and a few large pension funds dominate price formation.

As is well known, the restrictions on outflows imposed in 2008 were lifted in March 2017. They remain enshrined in law, however, so that they can be reinstated if the need arises. On the other hand, somewhat earlier, in June 2016, restrictions on capital inflows were introduced and a 40% special reserve requirement was imposed on investments in Icelandic bonds using new inflows of foreign currency. Such restrictions are based on a model from Chile in the 1990s. The main drawback of these restrictions is that they appear to be based on the assumption that investors' nationality determines whether they can be considered patient or stable long-term investors. For this reason, the said restrictions apply only to foreign investors. It is true that domestic investors are generally more loyal to the country. But this does not change the fact that investors show their time criteria mainly through which investment options they select. For example, those investors that buy long-term Icelandic corporate bonds must intend to own them for the long term, as there is a very limited secondary market for such securities in Iceland. The same cannot be said of those who buy short-term Treasury bills, for instance. Experience from other countries shows that domestic investors can be just as impatient as foreign investors, and nationality is therefore a very imprecise measure of patience.

It is beyond doubt that the inflow restrictions entail economic costs, although they may strengthen monetary policy transmission via the interest rate channel. The IMF has recommended against the use of inflow restrictions under the conditions currently prevailing in Iceland.[11] In their reports for the task force, Kristin Forbes (2018) and Sebastian Edwards (2018) concur with this view. Instead, they advocate the use of more precise and pointed tools in the spirit of macroprudentiality, which would aim at managing capital transactions in the spirit of good economics rather than prohibiting them. Restrictions would then be used only under duress, as in a financial crisis. They must not become an inalienable part of Icelandic monetary policy once again.

Lesson 9 – Success lies in prioritising objectives

In 1959, Robert Loring Allen, professor of economics at the University of Virginia, wrote a paper on Icelandic economic policy bearing the title *The vulnerability of Iceland's economy*. The opening words read as follows:

"Iceland is in a constant state of economic crisis. The country has attempted to achieve greater increases in the real standard of living than is justified by the productivity of the economy. The country has simultaneously invested at a phenomenally high rate, frequently in activities which have not contributed significantly to the growth of the economy. This pressure on Iceland's resources has resulted in a host of problems: chronic inflation, malfunction of the price system, government deficits, loss of its competitive position in world markets (at prevailing exchange rates), chronic balance of payments deficits, and policies which have not only failed to ease the situation but have even aggravated it."[12]

Even though Icelanders have certainly gained ground in the 60 years since this was written, it remains clear that certain factors described in this paper are still at play. It appears as though Icelanders are

11 International Monetary Fund. European Dept. (2017). IMF Executive Board Concludes 2017 Article IV Consultation with Iceland. Accessed at https://www.imf.org/en/Publications/CR/Issues/2017/06/22/Iceland-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-44998

12 The Vulnerability of Iceland's Economy Robert Loring Allen FinanzArchiv / Public Finance Analysis New Series, Bd. 19, H. 3 (1958/59), pp. 441-462.

unable to prioritise in terms of macroeconomic objectives, and it appears to be widely believed that Iceland can achieve more objectives simultaneously than is possible — or that monetary policy has been tasked with achieving far more objectives than it actually can, such as ensuring a higher standard of living than is warranted by economic productivity.

The fact is that, as an athletic trainer might say, if one sets one's sights on too many, and perhaps opposing, objectives, the result will be that none of the objectives are met. This is also the case with monetary policy. The practice of applying economic policy instruments arbitrarily, using what is convenient at any given time so as to achieve various different objectives in turn, as Iceland did in the 1970s, led to a fairly miserable outcome: inflation, unemployment, and instability.

At bottom, monetary policy centres on printing money (mostly in dematerialised form), or rather, ensuring the value of printed money that has no intrinsic value. A wrong approach or a misapplication of monetary policy can do considerable harm to the economy. On the other hand, monetary policy cannot ensure stability in the economy all by itself — not in terms of exchange rate stability, price stability or employment stability. Actually, many of the tasks that the general public believes to be within the sphere of monetary policy do not belong there at all: long-term real interest rates, long-term GDP growth, living standards, or income distribution. No country will grow wealthy by printing banknotes! What monetary policy can do is to ensure price stability within a given framework. Achieving other objectives depends on other aspects of the economy. It is this acknowledgement of the limitations of monetary policy that is the true foundation of inflation targeting — and allows the Central Bank to concentrate on what it can do rather than chasing goals that are actually beyond its grasp.

Achieving economic objectives often requires short-term sacrifice costs, such as a trade-off between inflation and unemployment. But such sacrifice costs disappear over time. Countries can have varying attitudes, understanding, or perhaps tolerance for inflation. For example, the Germans have little patience for inflation, probably as a result of the runaway inflation during the period between the wars. Other countries, such as the United States, have more tolerance for inflation and have placed corresponding emphasis on other monetary policy objectives, such as maintaining employment levels. These differing attitudes towards inflation led, among other things, to a split between these two participants in the Bretton Woods system in the early 1970s. But there still came a time when the US had to make a choice. In 1979, Paul Volcker became chairman of the US Federal Reserve Bank. Inflation was 15% at the time, but Volcker beat it back down to 3% in three years' time with tight monetary policy; however. unemployment soared to 10%. The unemployment rate declined again in the years to follow, but inflation has remained low ever since. Once again, as any trainer would say: no worthy goal can be achieved without some effort and hardship. In other words: no pain, no gain.

According to public choice theory, politicians have a commitment problem when it comes to large, difficult, and potentially unpopular decisions. As in the story of the Little Red Hen, everyone wants to eat the cake but no one wants to go to the trouble of baking it. Democracy can easily morph into an auction market, where each bidder tries to bid higher until the final outcome is far above economic reality. It was partly for this reason that central banks were given independence from government authorities, so as to ensure clear prioritisation of objectives, which is a prerequisite for long-term stability. After the sizeable pay hikes and steep rise in the real exchange rate over the past four years, Icelandic monetary policy is faced with a new test now that the business cycle seems to be heading downwards, partly because of cooling in the tourism sector. The question arises whether Icelanders can adopt more goal-directed governance practices.

Lesson 10 – Inflation targeting should be feasible for Iceland

Iceland has several unique characteristics that clearly complicate monetary policy conduct. The economy is extremely small. Its export sectors are homogeneous and prone to cyclical fluctuations. Most of its financial markets are not highly liquid, which results in spotty price formation. Not only is the currency area small, it is right between the world's two largest currency areas — the US dollar and the euro — which is bound to make it extremely difficult to pursue independent monetary policy. Prices are highly susceptible to exchange rate movements, and the foreign exchange market has proven difficult to manage. Conventional transmission of the policy rate along the yield curve also appears very limited, which further narrows the scope available to monetary policy.

There are other factors as well. Icelanders demonstrate a decided herd mentality in their consumption decisions, which causes wide fluctuations in private consumption. The country also has limited human resources to do everything that needs to be done, such as running healthcare, education, and governmental systems — not to mention managing monetary policy. Perhaps it is no wonder, then, that the Central Bank's *Special Publication* no. 7 from 2012, entitled *Iceland's currency and exchange rate policy options*, expresses certain doubts about whether it is possible for Iceland to maintain independent monetary policy successfully in the first place.[13]

Anyone discussing Iceland's monetary policy concerns is bound to acknowledge these problems. In a nutshell, it can be said that Icelandic monetary politics have focused primarily on manipulating the exchange rate of the króna, directly or indirectly. On the other hand, it is clear that the chief problems facing domestic monetary policy are not the systemic drawbacks Iceland has inherited through history and geography — factors that are not going to change. The biggest problems are institution, political, or perhaps societal: they centre on fiscal policy decisions, collective bargaining agreements, and overall societal consensus. It is possible to call this an institutional failure, something that is not written into the country's DNA but can be changed if the will is there. It is also worthwhile to warn against Icelandic singularism, as Jón Sigurðsson did in his time: "Many tend to focus on Iceland alone in the entire world and to reject the idea that other countries' experience could apply there."[14] Iceland is small, but in international context the other Nordic countries are also small, and they, too, depend on commodities exports. So the difference between Iceland and its Nordic neighbours exists but is not vast.

A look at the economic history of the Nordic countries — Denmark's pegged exchange rate, Sweden and Norway's adoption of an inflation target after 1990, or Finland's entry into the EMU in 1998 — shows that these countries were grappling with issues similar to those faced by Iceland: inflation, instability, and labour market unrest. They have worked through these problems successfully, however, and have incorporated the ground rules of monetary policy (no matter which particular policy was selected) into their social covenants.

Outside the Nordic region, the ground rules of inflation targeting have proven successful in democratic countries, in part because they demand transparency and public responsibility, which is consistent with the ground rules of an open democratic society. More specifically, inflation targeting is based on a simple division of tasks: the Government sets the target, and the Central Bank implements it. In 2001, Parliament approved the 2.5% inflation target almost unanimously, but there are numerous signs that the institutional commitment to price stability does not exist. It is also clear that Icelanders have found it very difficult to comply with the ground rules of this monetary policy framework.

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[13] Central Bank of Iceland. (2012). *Special Publication* no. 7: *Iceland's currency and exchange rate policy options* Accessed at https://www.sedlabanki.is/utgefid-efni/rit-og-skyrslur/rit/2012/09/17/Serrit-7-Valkostir-Islands-i-gjaldmidils-og-gengismalum/

[14] Jón Sigurðsson. (1843). *Um verslun á Íslandi (On trade in Iceland)*. Ný félagsrit (New Social Writings). Vol. 3.

Originally, when Icelanders sought sovereignty and then independence, it was not assumed that the country would pursue independent monetary policy. That role was more or less forced on Iceland after the collapse of the Nordic currency union. Nevertheless, people believed steadfastly at the time that Iceland could stand alongside the other Nordic countries in all respects, including monetary policy. Monetary sovereignty always represents value, as has been proven by the Great Recession and its aftermath. But the question whether the country wishes to wield this sovereignty — or sacrifice it for other overriding interests — must also be a matter of cold logic at any given time.

There is nothing to indicate that inflation targeting cannot work successfully in Iceland, as it has in the other Nordic countries, if we can reach a reasonable societal consensus on the ground rules accompanying such a framework. It is also the case, as any trainer can confirm, that the best thing about performing poorly at something is that poor performance gives one great scope for improvement. Institutional reforms relating to monetary policy implementation have certainly delivered improvements until now. For example, there are signs that entrusting a separate Monetary Policy Committee with taking interest rate decisions has enhanced the credibility of the Central Bank's monetary policy.[15] It is also beyond doubt that the targeted use of macroprudential tools in the past few years has strengthened monetary policy. The same is true of the new Act on Public Finances, which to some extent has curbed Government spending growth. There are enormous interests at stake here for the general public. The past four or five years' success in maintaining price stability has delivered a significant rise in purchasing power, and interest rates have fallen markedly. This gives rise to the question whether this success is a harbinger of lasting change or merely the calm between storms.

But the belief that Icelanders can stand beside other countries as equals, provided that they take the game seriously enough, should not be limited to athletic competition. Icelanders should be able to pursue credible economic policy just as its Nordic neighbours do — if they will only take the ground rules seriously. It is in this belief that the task force on monetary policy review presents its proposals for reforms to the current monetary policy framework.

[15]See the paper by Central Bank Chief Economist Þórarinn G. Pétursson: Central Bank: *Working Paper* no. 77: *Disinflation and improved anchoring of long-term inflation expectations: The Icelandic experience*. Accessed at https://www.cb.is/publications/publications/publication/2018/03/09/Working-Paper-no.-77-Disinflation-and-improved-anchoring-of-long-term-inflation-expectations-The-Icelandic-experience/