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The Icelandic currency and financial system

Based on a talk given at a conference to mark the 120th anniversary of Svarfadardalur Savings Bank (Sparisjóður Svarfdæla) on May 1, 2004

This article will give an overview of the 120-year history of the Icelandic financial system and present questions about the future. The occasion is the 120th anniversary of Svarfadardalur Savings Bank (Sparisjóður Svarfdæla, SPS), which was established on May 1, 1884. It was one of the first savings banks in Iceland and is also one of the oldest that is still fully operative.[2] Inevitably this will be a brief survey, but I shall try to shed light on a number of key issues.

What was the economic and monetary landscape in Iceland like when SPS was established in 1884? Iceland was one of the poorest and most underdeveloped countries in Western Europe. At the end of the 19th century, its GDP per capita was lowest among all the countries now classified as Western Europe, with the single exception of Finland.[3] Iceland at that time was part of the monetary system of Denmark, which had been in a currency union with the other Nordic countries since 1873. The Nordic currencies were on a gold standard, i.e. they were convertible into gold at a fixed rate. Consequently, there was free movement of capital between Iceland and Denmark. However, the domestic financial system was extremely underdeveloped. In 1880 the only financial institutions in the country were five savings banks.[4] International comparisons often evaluate the degree of development of financial systems by examining the ratio of broad money to GDP. Broad money consists of notes and coin in circulation and deposits in commercial banks and savings banks. It therefore provides a measure of the scope of monetary transactions and the domestic disposable funds of deposit banks available for lending. In Iceland this ratio was only 5% around the time that SPS was established, and there were constant complaints of a lack of money and credit in Iceland at this time.[5]

Since 1884, Iceland's economy and financial system have been revolutionised. National income per capita is the sixth highest in the world. Iceland is closely integrated with the global economy. Capital movements to and from Iceland have been almost completely deregulated since the beginning of 1995. Iceland has an independent Central Bank which implements monetary policy, and has its own currency, the value of which is determined by market forces.

This development would not have taken place without the growth and evolution of the financial sys-

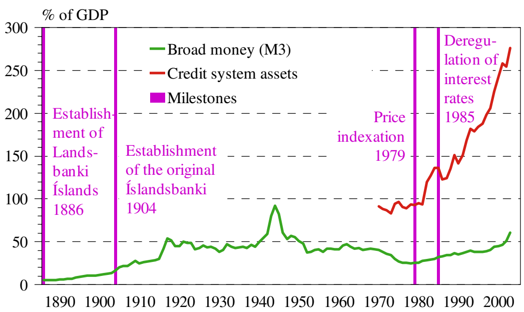
1. The author was Chief Economist of the Central Bank of Iceland when this talk was presented, but is now Deputy Head of the Monetary and Economics Department of the Bank for International Settlements (BIS) in Basel. The views expressed are those of the author and do not necessarily reflect the views of the BIS or the Central Bank of Iceland.
2. The history of the savings banks has been described by Haraldur Hannesson (1984). According to G. Karlsson (1975), the first savings bank in Iceland was established by landless farm workers in Skútustaðahreppur in 1858, but dissolved in 1864.
3. See G. Jónsson (1999), *Hagvöxtur og iðnvæðing – Þróun landsframleiðslu á Íslandi 1870-1945*.
4. See *Hagskinna* (1997).
5. This ratio is currently around 27% on average among the least developed countries in the world, and rarely drops below 10%.

tem. Relative to Iceland's size, it is now very strong. More than 100 financial institutions are operative in Iceland, including 4 commercial banks, 24 savings banks, 51 pension funds and 15 insurance companies. Modern financial markets, such as bond, equity, money and foreign exchange markets, have been created, although in some cases they have not acquired a modern form until the last decade. Broad money is now equivalent to 60% of GDP, while assets of the credit system as a whole, i.e. deposit money banks combined with pension funds, foreign credit, etc., are equivalent to almost three times GDP. The latter ratio is probably more comparable with the 5% ratio of broad money to GDP in 1884, which shows the quantum leap that Iceland has taken in this respect.

In what follows, an attempt will not be made to give a comprehensive answer to how this happened. It is generally acknowledged that financial system evolution and economic progress must go hand in hand, although it is sometimes disputed which came first, the chicken or the egg. I pointed out above that broad money was equivalent to 5% of GDP around the time that SPS was established. Chart 1 shows the development of this ratio since then, and also how the credit system as a whole has expanded since 1970. The establishment of the two commercial banks that in their day were authorised to issue banknotes, namely Landsbanki Íslands in 1886 and the original Íslandsbanki in 1904, gave a powerful impulse to this trend, but the growing number of savings banks also contributed. The ratio was just under 50% shortly before 1920, where it broadly remained until the 1950s apart from a spike during World War II.

Chart 1

Broad money since 1886 and size of the credit system 1970-2003



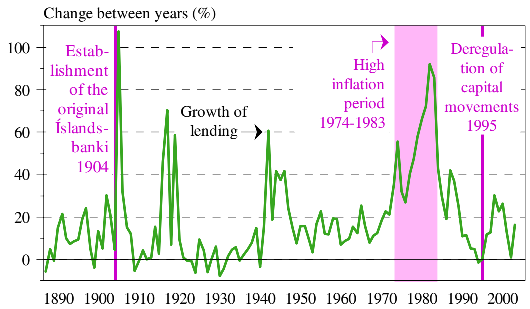
Sources: Statistics Iceland, Central Bank of Iceland.

Mounting inflation and negative real rates of interest in the 1970s, however, sent it tumbling. When the ratio hit a low just before 1980, there had been mounting concern for some time that inflation would undermine the domestic financial system and its ability to fund domestic business, and the share of foreign borrowing in the Icelandic credit system was growing rapidly. This trend was turned around with the introduction of price indexation in 1979, followed by deregulation of interest rates in the mid-1980s. The credit system then mushroomed in the 1990s with financial system reforms and sharp growth of pension funds.

Nonetheless, the development was uneven, as Chart 2 shows. Lending sometimes increased at a normal rate for a growing economy with low inflation. Sometimes it was sluggish, which was both the cause and the effect of business difficulties. Episodes of excessive credit expansion also occurred, either leading to financial instability when loan quality proved inadequate, or coinciding with high inflation, as in the period 1974-1983. The last credit boom took place following the deregulation of capital movements and financial system reorganisation which eventually coupled up with heavy macroeconomic imbalances in 2000. The question is, are we on this path again?

Chart 2

Growth of lending 1887-2003

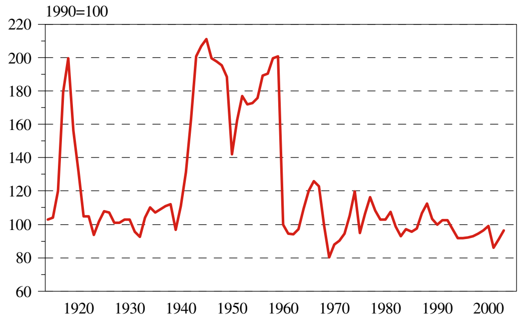


Sources: Statistics Iceland, Central Bank of Iceland.

The choice of an exchange rate regime obviously exerts a great impact on the development of the economy and the financial system. I mentioned earlier that Iceland belonged to the Nordic currency union around the time that SPS was established. The currency union collapsed when the convertibility of Nordic currencies for gold was abandoned at the start of WWI. However, the Icelandic króna kept its parity with the Danish krone until it was floated in 1922. In effect, the Icelandic króna first acquired its independent existence as a currency then. The króna floated until 1925, when it was pegged against sterling. That decision marked the beginning of one of the longest periods of fixed exchange rate in the history of the króna, lasting until a devaluation of 18% in spring 1939. Subsequently the króna was pegged against the dollar, and this arrangement continued until the end of 1973, although the level of the peg was repeatedly altered by the government over that period. During the high inflation period of 1974-1983 the króna virtually floated, despite being officially controlled. From 1983 onwards, experiments were made with using at least temporary exchange rate stability to curb inflation, which was running out of control at that time.[6] Inflation was later brought down to broadly the same level as in Iceland's trading partner countries through a variety of measures in the late 1980s and early 1990s, with a key role played by the decision in December 1989 to fix the króna at a realistic exchange rate.[7] When capital movements were fully deregulated in the mid-1990s, like most other countries Iceland experienced greater difficulty in maintaining a stable exchange rate and the policy could on occasion clearly come into conflict with the objective of price stability. The exchange rate was therefore gradually made more flexible in the closing years of the 1990s and eventually the króna was floated in March 2001. An inflation target was set for the Central Bank of Iceland and it was granted full instrument independence to attain it, first with an agreement with the government and later enshrined in law. Iceland has thus experimented with almost every exchange rate regime. The path lay from currency union and price stability to a floating exchange rate with price stability, but with severe bouts of instability in between. It is not certain that the final word of that story has been spoken.

Chart 3

Real exchange rate of the króna 1914-2003

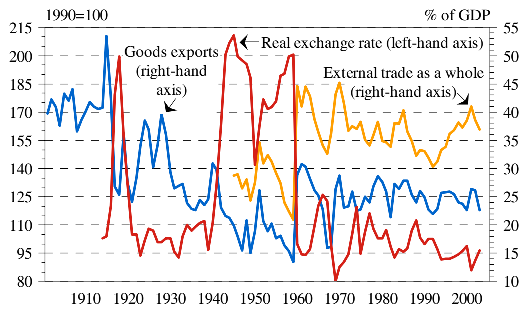


Source: Central Bank of Iceland.

Despite all the upheavals, the real exchange rate of the króna appears to have fluctuated around a stable central value, as shown in Chart 3, excluding the period of the two world wars when Iceland's possibilities for conducting international trade were seriously impaired. Chart 4, however, shows that goods exports declined steadily as a proportion of GDP until almost 1960. For the most part this probably reflects general economic developments and greater prosperity, with a corresponding expansion of the domestic market, rather than wrong exchange rate policy. But the excessively strong exchange rate from the end of World War II, and until the devaluation when the first economic liberalisation began under the "government of restoration" in the early 1960s, apparently hindered foreign trade, and goods exports and external trade as a whole rose in proportion to GDP following the devaluation.

Chart 4

External trade and the real exchange rate of the króna until 2003



Sources: Statistics Iceland, Central Bank of Iceland.

6. The history of Iceland's exchange rate is discussed, for example, in Nordal and Tómasson (1985) and Gudmundsson, Pétursson and Sighvatsson (2000).

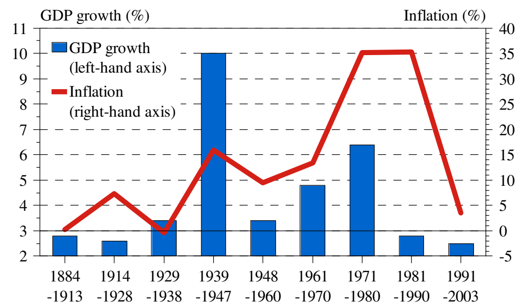
7. For a discussion of inflation, disinflation and the role of exchange rate policy in Iceland, see Andersen and Gudmundsson (1998).

As mentioned above, Iceland has developed from one of the poorest nations in Europe to the sixth most prosperous in the world in per capita terms. But this trend has been uneven, as Chart 5 shows, and for a long time instability was endemic. Apart from the boom during World War II, economic growth was strongest in the 1950s and 1960s, but this was also the period when inflation gained speed and even ran out of control for some while. In today's more advanced economy, such a robust pace of growth cannot be expected. Without allowing for the impact of temporary imports of labour, Iceland can be expected to sustain an annual output growth of just over 3% without imbalances and inflationary pressures forming.

Chart 5

GDP growth and inflation 1884-2003

Annual average for each period



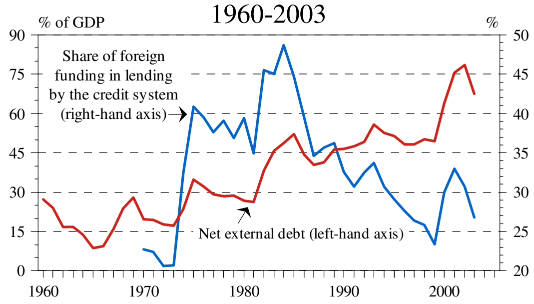
Source: Statistics Iceland.

Output growth in recent decades went hand in hand with continually mounting foreign debt as a proportion of GDP, as Chart 6 shows. To a large extent this reflects a persistent current account deficit over this period. This need not be unnatural in light of the extensive development that took place over these years and the young average age of the population, but debtors are of course more sensitive to shocks than those who owe nothing. Interestingly, despite this development the share of foreign funding in the credit system has been decreasing since the mid-1980s, which reflects rapid growth in the stock of financial saving at domestic financial institutions. This is rather at odds with claims that the króna has been dwindling in importance.

How have the savings banks performed during these developments? As it happens, quite well, as Chart 7 shows. After the original Íslandsbanki had established itself towards 1910, savings banks accounted for around 15% of deposits and, with a few exceptions, remained roughly around that level until almost 1990. Since then the savings banks have been gaining ground.

Chart 6

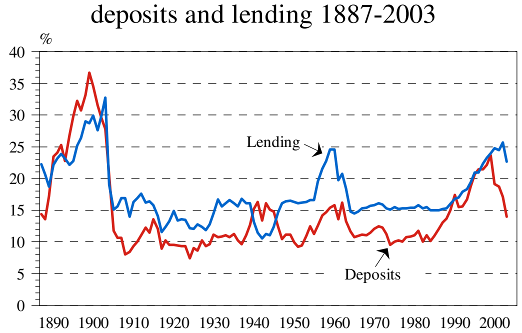
Net external debt and share of foreign funding in lending by the credit system 1960-2003



Sources: National Economic Institute, Central Bank of Iceland.

Chart 7

Share of savings banks in total bank deposits and lending 1887-2003



Sources: Statistics Iceland, Central Bank of Iceland.

It may be worth following up this historical overview by considering the future in light of past experience. There is no question that the inflation target and floating exchange rate that were adopted in March 2001 have produced good results. The inflation target was attained towards the end of 2002 and although inflation has been rising recently it still remains within the tolerance limit, and at least in part is explained by temporary external factors such as soaring oil prices. At the same time, exchange rate developments contributed to better macroeconomic balance, and the wide current account deficit that built up at the end of the last upswing disappeared in 2002. After the exchange rate completed its adjustment following the systemic reforms, it has been considerably less volatile than is the norm, for example, for larger currencies.

Nonetheless, it cannot be claimed that Iceland has reached home base as far as the exchange rate regime is concerned. Participation in the European single currency would obviously have various advantages for Iceland. One would be to stimulate imports and exports by eliminating the exchange rate risk inherent in a large part of Iceland's foreign trade. Research suggests that increased foreign trade provides an impulse to economic growth, at least in the short run. Access to large capital markets without exchange rate risk would also entail a number of benefits. Competition would be enhanced and costs would decrease, without necessarily raising the risk profile for the financial system as a whole. The reason is that the risk of a localised Icelandic currency crisis would be a thing of the past and the Icelandic financial system would have access to a much wider safety net than today. But such a step would also entail various disadvantages, the greatest being that the possibility of applying an independent monetary policy to respond to localised shocks would no longer be at hand. It is clear that such a step will not be made unless Iceland joins the European Union. That, in turn, would involve a political decision embracing a range of wider factors than the exchange rate regime and monetary policy. However, if the point is reached when that step is taken, to some extent we will then be in the same footsteps as when Svarfadardalur Savings Bank was established 120 years ago.

So what can be said about the future of Icelandic financial institutions? Icelandic banks are currently expanding across borders, which has brought them growth on a scale once thought impossible. If Iceland becomes part of the euro area the result would not only be tougher competition facing Iceland's financial institutions, but also more scope for their international expansion. Nonetheless, it is very likely that there will continue to be a need for localised financial institutions that know the individuals and the small and medium-size enterprises in their community and thus have an advantage in evaluating their creditworthiness. There are few obstacles to savings banks performing that role, but in order to survive, the savings banks, like all other financial institutions, will need to adapt to ever-changing conditions.

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