Asgeir Jonsson: Macroeconomic stabilisation in small open economies – challenges and lessons: The Icelandic experience

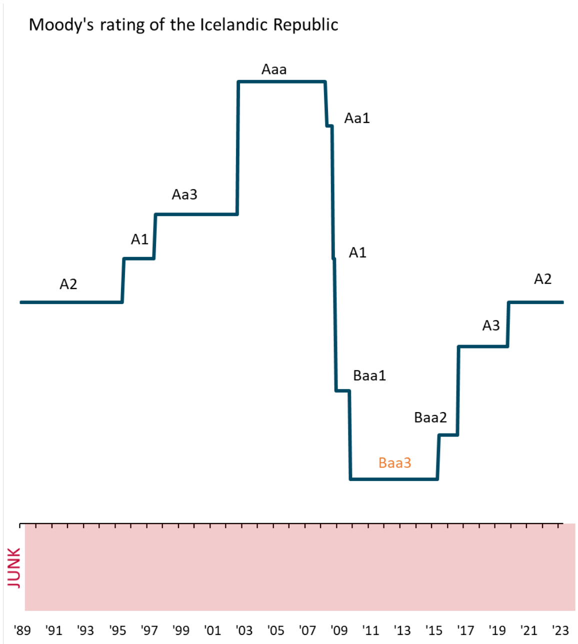
Opening remarks at the Reykjavik Economic Conference by Mr. Asgeir Jonsson, Governor of the Central Bank of Iceland, Reykjavik, 23 May 2024.

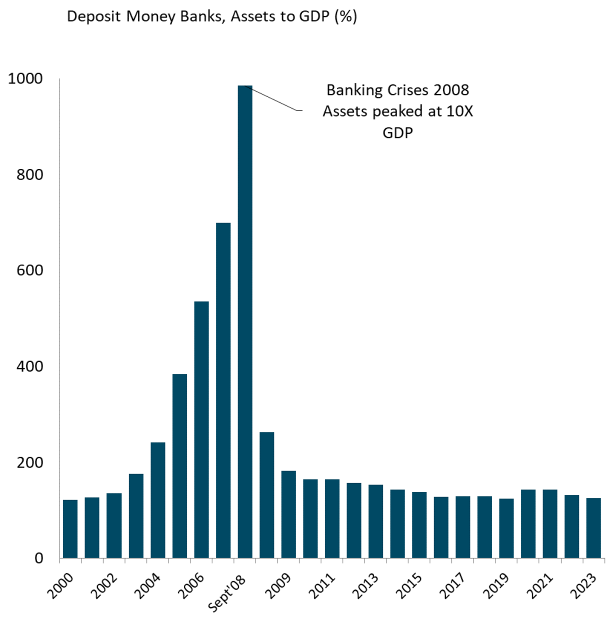
I am very pleased to welcome you to Iceland and to the first Reykjavik Economic Conference. Our ambition is to hold a conference of this kind annually. I would like to thank our colleagues at Northwestern University for very rewarding and pleasant cooperation in preparing the conference and in lining up an impressive list of speakers. I would especially like to thank Sergio Rebelo and Martin Eichenbaum who are not only here as participants, but also as hosts and organizers. We have ahead of us a two-day comprehensive program of presentations and discussions. We have among us academics, policymakers and practitioners which should ensure a fruitful dialogue and debate.

Distinguished academics will present and discuss papers on various topics of relevance, there will be keynote presentations on key matters pertaining to central bank policies, and four panel discussions filled with respected panelists, Governors, other central bankers and academics. The topics for our sessions over the next two days, the promise of macro-prudential policies, currency market intervention, fiscal sustainability and the current account and stabilization in small open economies - whether they have independent monetary policy or not - are all relevant to the challenges which we as central bankers face, each in our own country.

Our main focus is on small open economies or stabilization in small open economies. Being small does not necessarily make life simpler, even quite the contrary. Participating in the conference are several governors from small open economies in various parts of the world. They have very different currency arrangements, but nevertheless we all have in essence the same challenges to deal with. I look forward to the discussions.

I would like to take a few minutes to discuss the Icelandic economy, developments before the 2008 crisis and the resurrection of the financial system - or how we rebuilt our financial system after the crisis. These graphs can be said to be emblematic of the economic landscape in Iceland before the financial crisis. The Icelandic Republic received a AAA rating from Moody's in 2002 and in its wake we were flooded with foreign credit. In this environment the Icelandic banks sought to build an international banking system with extensive operations in other countries, both through subsidiaries and branches. In 2008, the banking system in terms of total assets had grown to ten times our GDP. After the bankruptcy of Lehman Brothers in September 2008, there was a sharp shift in sentiment; we thought that we had an international banking system, but the outside world saw our banks as being oversized Icelandic banks. They had, in fact, moved from the being too-big-to-fail to being too-big-to-save.



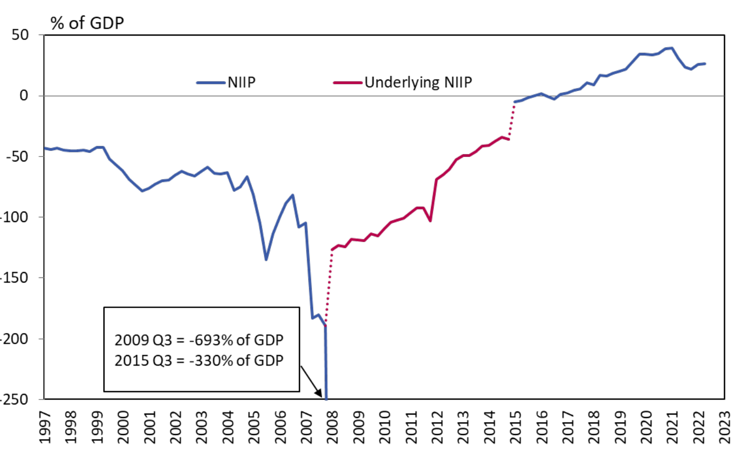


There is a saying that banks are only international when they are alive and well, but when they get into trouble, they become a domestic concern. The Icelandic government responded to the crisis by a force majeure act involving dividing the banks into two parts: A domestic part that was recapitalized and given to the creditors, and a foreign part that was liquidated. The FSA was given sweeping authority to take effective action. That is how we were able to slim the banks by 80% almost overnight.

In the wake of the crisis, he currency depreciated by 50% and capital controls were introduced in cooperation with the IMF at the same time as Iceland entered an IMF Stand-by arrangement. For the IMF, implementing capital controls in an advanced economy was a groundbreaking event. Instantly we were faced with a double FX market, an offshore unofficial currency market and an official domestic one. The currency depreciated by 70-80% in the offshore market from the pre-crisis level and a wide difference prevailed between the official and unofficial exchange rate for most of the period of the capital controls. I should mention that my predecessor, Már Guðmundsson, was in charge of implementing the capital controls as well as stabilizing the economy, and on his watch, the capital controls were successfully abolished in 2017.

The controls allowed us to restructure the banking system without the risk of capital flight and allowed the government to refinance itself, which otherwise would have been difficult at best given the massive fiscal outlays caused by the crisis. However, as the restructuring of banks proceeded, large amounts of capital were locked in the country behind the capital controls which also gave the authorities bargaining power in resolving legal disputes with hedge funds which by then had bought a majority of the outstanding

Net international investment position[1]



1. Based on underlying position from 2008 through end-2015; i.e., adjusted for the effects of settling the failed banks' estates and assuming equal distribution of assets to general creditors. At the end of 2015, the estates of the failed financial institutions reached composition agreements entailing the write-off of a large portion of their debt. As a result, there was no difference between the NIIP and the underlying NIIP.
Source: Central Bank of Iceland

claims on the defaulted banks. However, just like the American saying goes; never let a good crisis go to waste, one of the good things of a collapsed financial system is that you can build a new one on a much sturdier foundation and a craftier design. Ever since the crisis we have worked hard to build a new, sound and robust banking and financial system. This has been the work of many. The main goal has been to establish resilience to shocks. This we have achieved and the overall results can among other things be seen in the development of the net international investment position which is now positive. The Icelandic economy has moved from being in debt to the rest of the world to being a creditor country - which is in a way a testament to our policies.

I would like to quote Helen Rey on how you create resilience: *"Independent monetary policies are possible if and only if the capital account is managed, directly or indirectly, regardless of the exchange-rate regime"*

Today, I will discuss six lessons that may be drawn from the Icelandic experience of building a "new" financial system. First of all, one actor in charge. One of the main problems prior to the crisis was that there was no single actor responsible for financial stability. We had several actors with unclear responsibilities. But with the merger of the FSA and the Central Bank in 2020, the chief responsibility for financial stability was assigned to one institution, the Central Bank. Following the change in the Central Bank Act in 2020, three committees take all Central Bank policy decisions: the Monetary Policy Committee, the Financial Stability Committee, and the Financial Supervision Committee. All the committees have external as well as internal members. The set-up, inter alia with official policy statements and publication of minutes, ensures transparency in the decision making, how decisions are taken and why. In my capacity as Governor, I chair all three committees, but I have only one vote when decisions are taken.

Second lesson, managing the balance of payments. We abolished the capital controls, but we have maintained indirect control of the balance of payments through macroprudential policies and measures and also by building up and strategically using our foreign currency reserves. In 2011, there was a volcanic eruption in Iceland, which you may remember because air traffic came to a halt over the North Atlantic and much of Europe for a couple of weeks. We have this saying; all publicity is better than no publicity, and even very negative publicity became a fiery start of the tourism boom in our country. Tourist arrivals went in just a few years from 300,000 per year to 2.5 million. When the tourist boom took off the Central Bank used the opportunity, provided by the associated currency inflows, to accumulate foreign reserves in the open market. Since then, we have used the reserves to maintain stability and ensure liquidity in the currency market. We also have specified limits on domestic entities' ability to take on foreign credit. The banks do not lend to households or companies in foreign currency unless they have revenues in foreign currency. We have limits on FX futures and derivatives to prevent short-term speculation, as one of the main problems that we faced before the 2008 crisis was carry-trade speculation. So far, we have been able to maintain stability in the balance of payments and our currency despite a large interest rate differential vis-à-vis our neighboring currency areas.

The third lesson is that the best recipe for economic stability is integrating macroprudential and monetary policy in managing credit growth and leverage ratios. The Icelandic banks are well funded and have among the highest liquidity and equity ratios of banks in the advanced economies. We require high capital buffers, countercyclical buffers, and systemic buffers as well as employing other regulatory requirements. We have also introduced borrower-based measures to cap lending to households. Households are required to have at least 15% equity in order to buy a home and the maximum debt servicing capacity of 35% to income. For the past two or three years, the Central Bank's main goal has been to prevent a boom in the real estate sector from being transmitted into the financial sector while the real economy has grown at a rapid pace. In the years 2021 to 2023, the economy grew by a total of 20% in real terms which is very strong on any scale. The Bank has indeed succeeded in preventing excessive borrowing and indebtedness, or the development of a debt bubble. We have seen negative real credit growth for the past 12 months, and a rise in equity ratios for households and most businesses. Nevertheless, it is very important for a small open economy to focus on credit growth. Excessive growth of credit over time always leads to trouble in the balance of payments, a current account deficit, or an imbalance in capital flows.

One of the main challenges which we faced after the crisis was to restore public trust. Thus, the fourth lesson is transparent and proactive supervision, which is the key to public trust. It was, I think, highlighted when problems occurred with the small and regional banks in the US, like Silicon Valley Bank. It is very important to draw both systemic and systematic conclusions from supervisory data and not get lost in the details. Strict rules on conduct play an important role in the Icelandic financial market regulation, caps on bonuses, restrictions on lending to related parties, restriction on banks to carry out financial undertakings secured with its own shares, restriction on strict fit and proper rules for board members and so on. Strict regulations and effective supervision are a key to the public trust.

I think it is now widely accepted that it was appropriate to give the responsibility for financial supervision to the Central Bank. The supervisor is much stronger having the central bank behind it which also allows for a much stricter enforcement.

The fifth lesson is that consensus with the labor market improves policy trade-offs. The Scandinavian approach is to have general centralized wage bargaining, which is something we have struggled with in Iceland in many ways, but in March 2024 a four-year wage contract was negotiated reached between the main labor market participants which we hope will assist in the fight against inflation and bringing it to target. The Central Bank policy rate stands at 9.25% and inflation is still much too high, hovering around 6%, but projected to subside.

The sixth lesson is that monetary policy needs political support, that is support from the political establishment and the public. In a way, the Central Bank still faces the legacy and the memory of the crisis. Indeed, the Central Bank has had full support from the political establishment so far and in my opinion, from the public as well in carrying out its mandate and policies after the new Central Bank Act came into force in 2020. Monetary policy and other Bank policies can never be a private matter of what we economists or appointed officials support or decide. They must have public support. Without public support, it is very difficult for the Central Bank to carry out its responsibilities.

As I said, and to conclude, we have faced many challenges, and I would think that my predecessor sitting here in the audience would agree. Since I took office, five years ago, we have faced many shocks: From COVID and the effects of military conflicts abroad to volcanic eruptions at home, but also positive supply shocks because after COVID Iceland experienced positive trade terms and trade shocks. The world market price on marine products and on aluminum and power rose markedly. We have experienced very rapid growth, a very tight labor market, and we have had to tighten policy, both monetary and macroprudential policy.

One can always wonder or think how much authority can be given to the Central Bank. How much authority can be given to un-elected officials, meddling with housing policy, affordability of housing for example, or how lending is managed. Nevertheless, our framework is based on clear mandates, transparency and accountability, and I think that in many ways Iceland can be compared to a laboratory. I would like to think that our experience could provide some valuable lessons for other countries, especially how to integrate macroprudential and monetary policies. I think we are the only nation that has a population below 2 million that implements its own independent monetary policy and all other policies, which can be challenging at times, situated as we are, between two large currency areas, the euro area and the US.

But as I said at the outset, I look very much forward to the presentations and to our discussions over the next two days.