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After 100 Years of Experimenting: One Solution?

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Introduction

Iceland gained sovereign rights on 1 December 1918 with a secession from Denmark, and thereby became a separate currency area. The country is thus currently celebrating a centenary anniversary of monetary independence. In Iceland's campaign for independence in the early twentieth century, 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. 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 WWI ended. Not only had the currency cooperation among the other Nordic countries disintegrated, but Iceland began its life as a sovereign nation

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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 in the sharp worldwide depression that followed the war. 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.

During these 100 years of sovereignty, Iceland has experimented with almost every type of monetary arrangement one can imagine. The country 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 EMU—until the creation of the Euro in 1998. Since Iceland is not formally a member of the EU, a formal membership to the European Monetary Union is off limits. The country has also engaged in various other policy experiments on its own, like unilateral nominal exchange rate targeting, money supply targeting, and real exchange rate targeting. Lastly, in 2001, the nation adopted an inflation target with a free-floating exchange rate and now, since 2009, a flexible inflation targeting supported by capital controls. The results from these experiments can be viewed as dismal. Inflation and currency volatility have been a constant problem. As the result, the Icelandic krona has lost about 99.95% of its value against the Danish krona since 1918. Although an official inflation target of about 2.5% was adopted in 2001, it was not until very recently or since 2014 that the target has been reached in a sustainable manner.

The monetary problems Iceland has faced are also manifested by the fact that country has been under capital controls from 1931 to

1994 and again from 2008 to 2017. And currently, a Chilean-style reserve requirement on inbound foreign capital are still in place, and are a viewed by the Central Bank of Iceland as an integral part of its monetary policy. Therefore, during the century of monetary autonomy, currency exchange with the Icelandic krona has only been free for a total of 27 years.

By invoking capital controls in the wake of the financial crisis in October 2008, the Icelandic authorities were able to restructure the banking system and lower interest rate without the risk of capital flight or a bank run. This also allowed the Treasury to refinance its debt at a much reduced rate after the crisis. Furthermore, having the controls gave the Central bank bargaining power against the hedge funds which held majority stakes in estates of the defaulted banks. These estates held large sums of ISK denominated assets, which were destined to be paid out to foreign creditors and thus created an almost unsurmountable transfer problem for the Icelandic currency market.

After a 2- to 3-year stand-off between the creditors and government, a settlement was reached by June 2016, which the creditors of the fallen banks agreed to hand over all ISK denominated assets as a stability contribution to the Icelandic Treasury. Thereby, the estates of the failed banks were allowed to enter composition and pay out the foreign asset of the estates to creditors. The stability contributions amount to a transfer of 3.3 bn. USD or 20% of Iceland's GDP. In 2011, the IMF estimated the direct fiscal cost of the crisis to be 41% of Iceland's GDP and 19% in net terms—thus the Icelandic banking collapse was considered the costliest crisis in history. With the stability payments, the treasury has been completely reimbursed for direct costs from the banking collapse, and has a net gain 3–9% of GDP, depending on the value of the banks.

With this hurdle out of the way, the outbound capital controls were abolished on 12 March 2017. On the very same day, Government has also appointed a taskforce dedicated to reviewing monetary and currency policies with a view to creating a future framework for the continued use of the Icelandic krona as Iceland's legal tender. Otherwise, no options were off the table. The taskforce included this author as a chair and two other economists: Ásdís Kristjánsdóttir, and

former minister Illugi Gunnarsson. The task force engaged the following economists to advise the authorities on Iceland's future monetary and exchange rate policy options:

Patrick Honohan, former Governor of the Central Bank of Ireland, and Athanasios Orphanides, Professor at Massachusetts Institute of Technology (MIT) and former Governor of the Central Bank of Cyprus, to assess Iceland's experience of inflation targeting and propose possible reforms. Sebastian Edwards, Professor at the University of California at Los Angeles (UCLA), to evaluate monetary policy options for Iceland other than the current inflation target. Kristin Forbes, Professor at MIT, to examine the application of financial stability instruments.

Lars Jonung, Professor at the University of Lund, and Fredrik N. G. Andersson, Associate Professor at the same university, to explore Icelandic monetary policy in a Nordic context.

The taskforce and its advisors delivered their reports on 5 June 2018, which are downloadable from the website of the Icelandic prime ministry.[1]

In the view of the taskforce, the following 10 lessons can be drawn from Iceland's 100-year monetary history and one conclusion for future policy framework of the country. These lessons—of course—can also apply elsewhere:

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

All currency frameworks have their pros and cons, and their ground rules. 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—either as regards

[1]https://www.government.is/news/article/?newsid=8a320626-68c4-11e8-942c-005056bc530c.

application of economic policy instruments or as regards maintaining general economic stability. Because of this, each monetary policy framework has in effect disintegrated, and the nation has been forced to tolerate persistent instability and the highest known nominal 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 based on class struggle emerged in Iceland as in most other European countries. For some reason, conventional stabilisation policy, which is based on applying monetary and fiscal policy instruments so as to mitigate cyclical volatility, has never gained a foothold in the "new" political system in Iceland. 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 independence to set interest rates policy 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.

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

In such a small, open economy as Iceland's, where a large share of consumer goods is imported, it is possible to achieve a rapid real wage growth in the wake of a favourable terms of trade shocks or increase in export volumes, due to e.g. fluctuations in the fishing stocks around the island. In addition, nominal wages can rise in excess of productivity with the appreciation of the real exchange and lower import prices. These benefits are generally short-lived—and they generally reverse. Wage rises in excess of productivity are bound to erode the 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. During the last 100 years, Iceland has been brought to insolvency three times—that is in 1920, 1931, and 1946—through a combination of export shocks and real exchange rate appreciation brought about by overheating and rampant nominal wage increases.

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 income within the nation, 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.[2]

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. However, the fact is that the wage gap is generally rather small in Iceland compared to that abroad. Moreover, the remuneration for education is much less in Iceland than elsewhere in the OECD, especially in terms of disposable income.

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. Thus, 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.

[2]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.

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—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. 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.

Denmark has maintained 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.

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. 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. Nevertheless, 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. This is something which the Icelanders have never been able to follow through.

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. 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. 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 to which Icelandic authorities have responded by imposing capital and even trade controls.

This balance of payments problem has only grown in recent years, following liberalisation of capital transactions and increased global capital flows. 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 in the Icelandic financial system. As a result, Iceland became actually insolvent—for the fourth time since sovereignty. 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".[3]

It is abundantly clear that the Central Bank must 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 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.

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

[3]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.

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.[4] 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.[5]

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—to maintain economic stability in face of an immense asset bubble. Attempts to achieve the legally mandated inflation target 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—leading to the financial crisis of 2008.

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

[4]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.

[5]"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.

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 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.

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

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.[6]

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

[6] Cecilia Skingsley. (2016). *Objective-Setting and Communication of Macroprudential Policies*. Bank for International Settlements. Accessed at https://www.bis.org/publ/cgfs57.pdf.

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.[7] 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.[8] 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.[9]

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. 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: Capital controls bear very large welfare costs

In the struggle for independence in the nineteenth century, a demand for free trade became almost like a battle cry. In the eyes of the main leader of the independence movement, Jón Sigurðsson, 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

[7] 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.

[8] 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.

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

in Iceland) were abolished in 1855. And free foreign trade became like an undisputed maxim of Icelandic politics—all the way up to sovereignty in 1918. 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 described above, 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.

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 about 160% of GDP, only one-fourth of which is invested abroad. It would be best if that foreign ratio were closer to 50%.[10]

[10]Asgeir Jonsson 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 Fridrik Már Baldursson and Richard Portes (2018). "Restoring Trust in Iceland: Iceland's IMF Programme," in Thröstur Olaf SigurJonsson, Murray Bryant, and David Schwarzkopf (eds.), *The Return of Trust? Institutions and the Public After the Icelandic Financial Crisis* (Emerald Publishing), pp. 111–127.

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 financial institutions are the only participants. The result is wider commercial 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. Nevertheless, one would 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

It is of course a well-known fact that 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 exactly 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 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. According to public choice theory, politicians have a commitment problem when it comes to large, difficult, and potentially unpopular decisions. 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. 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.[11]

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

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[11]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/.

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. 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.

Conclusion

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. One can very easily argue that the lack of success is due to a lack of scale. Iceland—with a current population of about 350 thousand—is the smallest currency area in the world by far as no other nation with population below 2 million is attempting to implement in its own independent monetary policy. Nevertheless, 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.

The only way to achieve a permanent exchange rate stability is through either a monetary union through a Euro membership or establish a currency board. The Euro option is only available through a full EU membership, which has so far been politically infeasible in Iceland. The Currency board option contains two critical flaws that makes it a very impractical option for Iceland. First, it's not all obvious that an Icelandic currency board would constitute a permanent exchange rate rather than a soft peg. True, the board is written into law—but laws can be changed overnight and even without a large punishment from international markets. During its history, Iceland has often faced gigantic balance of payment problems given the concentration of the export base and its difficulty with economic stabilisation. Why should the Icelandic authorities not resort to devaluation as they always have in past rather inflicting dire economic pain on the population? Second, under a currency board the burden of adjustments is through short term interest rate setting in the financial sector—which is in fact has no lender of last resort. The only way the Icelandic financial sector would credibly be able to shoulder this burden is if the banks would be owned by international parties with sufficient standing to provide them with liquidity backstop, just as was the case with the Baltic countries. Otherwise, leaving the banks again with a credible lender of last resort—as happened in 2008—would be an invitation for another banking collapse.

There is nothing to indicate that inflation targeting cannot work successfully in Iceland, as it has in the other Nordic countries, if the population

could reach a reasonable societal consensus on the ground rules accompanying such a framework. 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.[12] It is also beyond doubt that the targeted use of macroprudential tools in the past few years has strengthened monetary policy implementation. 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.

The application of macroprudential tools centres not only on maintaining financial stability—this new way of thinking and/or methodology can also hone monetary policy by curbing credit growth and leverage in the economy. This has particular significance for small currency areas where a widening foreign interest rate differential can cause balance of payments problems and create the risk of financial and economic instability. These problems lie not only in foreign exchange market instability, but also in inflows of foreign capital into the financial system, causing credit and asset price bubbles.

The understanding is now gaining currency that, because of the globalisation of capital transactions, independent monetary policy is not truly an option for smaller currency areas unless it is possible to manage the capital account, directly or indirectly, irrespective of the exchange rate regime in place. This can be done with capital controls, but it can also be accomplished with appropriate application of macroprudential tools. Macroprudential tools can create a stronger foundation for

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[12] See the paper by Central Bank Chief Economist Thorarinn G. Petursson: 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/.

independent monetary policy in small, open economies by improving the transmission of monetary policy to the real economy via the so-called credit channel. This would accomplish the task that capital controls were designed to carry out, but at much less cost to the nation.

One could say that through the century of monetary sovereignty, the nation has wrestled with two conflicted objectives; on one side reaping the benefits of a comparative advantage through free trade but on the other preserving stability by attempting to control balance of payments transactions. The struggle will continue into the second century of monetary independence.