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Payment intermediation, inflation, and the new 10,000 kr. banknote

Már Guðmundsson, Governor Speech at the launch of the new 10,000 kr. banknote, Central Bank of Iceland, 24 October 2013

Minister, Supervisory Board members, bank directors, ladies and gentlemen:

Iceland's new 10,000 króna banknote is being put into circulation for the first time today. The introduction of a new banknote is far from an everyday occurrence: Iceland last saw a new note launched 18 years ago, when the 2,000 kr. banknote was put into circulation, and the 5,000 kr. note was first circulated 27 years ago.

But why do we need a new note with a higher denomination? Isn't use of cash that limited and use of electronic payment methods that widespread in Iceland? Yes; Icelanders use payment cards more than other countries do. About 90% of all retail sales transactions are carried out with cards, and for decades, use of banknotes and coin – what we call cash – equalled only about 1% of GDP. Then, in autumn 2008, the banks collapsed, and use of cash more than doubled. At present, cash in circulation amounts to about 38 billion krónur, roughly 2% of GDP. But even though Icelanders' use of cash has doubled recently, we are still among the lowest in our comparison group, together with Norway and Sweden.

But the need for a larger banknote had developed even before this surge in the use of cash, and the Central Bank began preparing for the new issue as early as 2006. Experts consider it appropriate to issue a banknote with a larger denomination if the largest note currently in use accounts for 70% or more of circulation. Iceland's 5,000 kr. note has been above this threshold for six years, with a share of 87.3% at the end of 2012. In comparison, when the 5,000 kr. note was launched in June 1986, the 1,000 kr. banknote, then the largest in use, accounted for 74.5% of total circulation. In other Nordic countries

with an independent currency, this ratio ranges between 24% and 54%.

In view of this, the issuance of a 10,000 kr. banknote at this point in time must be considered a modest step that takes account of the fact that payment intermediation in Iceland is electronic to a large degree and is extremely efficient, and transactions are conducted in real time. The primary objective is to streamline use of banknotes, as demand is met with fewer notes than before.

But there is no denying that, when all is said and done, the issue of a new banknote is bad news, as it results from excessive inflation in Iceland over the past few decades. When two zeroes were truncated from the Icelandic króna at the beginning of 1981, the highest-denominated banknote in circulation was 500 kr., the equivalent of about 20,000 kr. in today's terms.

The value of Iceland's currency (the króna) has deteriorated by nearly 98% in the interim. The lion's share of the erosion took place during the first decade, however, as inflation averaged almost 31% during the 1980s, peaking at 102.7% in August 1983, and the króna shrank in value by some 93% in the 1980s alone. However, inflation averaged about 3% in the 1990s and has averaged just under 6% since the turn of the century. In a longer-term perspective, we have made progress in reducing inflation in Iceland. But we can still improve on this, as inflation is now around 4%, which means that the value of our money will deteriorate by over 32% in a decade. Based on our inflation target of 2½%, that figure would be just under 22%, so there are clearly significant gains to be made.

The history of Icelandic banknotes extends further back than 1981, however, and the history of paper currency around the world is much longer. Paper banknotes issued by central banks are one form of money, but in the historical scheme of things they are a relatively new development. In one form or another, money has been in use at least since the time of the Sumerians, some 10,000 years ago. Money is generally defined as an object whose use is agreed upon in a given region or country as a medium of exchange for goods and services or to settle debt. Many societies first began to use specific goods as generally accepted units of account and as a medium of exchange; e.g., metals, woollen cloth, fish, or livestock. Gold ultimately became the most accepted medium, however. Later, instruments of debt, or bills of exchange for such valuables, came into use, and they became commonly used to settle trades and debts. Originally, paper money took the form of such bills of exchange, which were redeemable in terms of a specific item, often gold. These bills could be issued by individuals and companies run by them, and later on private banks issued such cheques or banknotes. Still later, central bank notes developed, without redemption in gold or other goods, much like the

banknote we are launching today. Each of the stages I have described enhanced the efficiency of payment intermediation, but as such notes are no longer redeemable for other valuables, they are ultimately based on the valuables that are produced in the country and can be bought for such notes, and on the confidence in the state that issues them.

The first recorded use of paper currency in history dates from seventh-century China. Notes used in China in the 11th century can still be seen in museums, but the best-known of these old forms of money are the Chinese notes from the 13th century, described by Italian explorer Marco Polo upon his return from the Far East.

In Europe, Italian financiers and the Flemish were the first users of paper currency. The first banknotes were issued by the Swedes, with the forerunner of the Riksbank, established in 1668, issuing banknotes in 1661. These were the first banknotes not linked to deposits; they were based on the confidence in the owner's ability to withdraw from the bank the amount specified on the note. It was therefore tempting for the bank to issue larger amounts of notes, which led initially to the first economic boom in Sweden but ultimately to inflation, and finally depositors were unable to withdraw their balances in the copper coins then used as money, except at a discount.

At the time, some maintained that no one should ever try to issue paper money again, but that pessimistic attitude was short-lived. Issuance of banknotes gradually became established by the end of the 17th century, around the time the Bank of England was founded and began issuing notes in 1694. But the cautionary tale of Sweden's early effort reminds us of the dangers accompanying the issuance of paper money and how a glut of notes can contribute to inflation.

The history of official currency in Iceland began in 1778, with the formal validation of Danish Courant Bank notes with Icelandic text printed on the reverse (the note is on display in the numismatic collection). These notes were not used widely, however, because during the time of the trade monopoly, most people relied instead on barter, and Icelanders tended to trust precious metals rather than the Courant Bank notes. When Landsbanki Íslands was founded in 1886, the Icelandic Treasury issued a series of notes denominated in krónur instead of the previous *rigsdaler*. With the establishment of the Scandinavian Monetary Union in 1873, the Scandinavian countries all replaced their currencies with a standardised króna (crown) that was nonetheless designed and issued by each country independently. The national treasury of each country was responsible for issuing the notes, which were backed by gold until the Great Depression in the 1930s.

In Iceland, banknotes have been issued continuously since 1778 by a number of issuers: the Danish Courant Bank, the Icelandic Treasury, the Republic of Iceland, the Bank of Iceland, Landsbanki Íslands, Landsbanki Íslands-Seðlabankinn, and now the Central Bank of Iceland. In these 235 years, a total of 63 different issues have been launched, including the note introduced today. As regards redemption of paper currency with metals, notes issued by the Bank of Iceland in 1904 specified that the bank would pay the bearer the value of the note – from 5 kr. to 100 kr. – in gold. These notes are on display here in the numismatic collection.

The collection you see here is part of the Central Bank-National Museum of Iceland numismatic collection, part of Iceland's museum system. The numismatic collection is jointly administered by the Central Bank and the National Museum. Copies of the new banknote will be stored here permanently, as I will touch on again later.

We are now introducing the new 10,000 kr. banknote, but what does the future hold? There are no plans to issue a larger note at this point in time, and whether such an issue proves necessary later will depend on inflation and demand for banknotes in general, including the new one.

Another question worth asking is whether there are changes ahead concerning our smallest denomination, and whether the 500 kr. note should perhaps be replaced with a coin. No decisions have been made about this, however. In general, future developments depend on demand for cash, which in turn depends on inflation and technological advancements. It is the Central Bank's aim to meet demand effectively and efficiently, but in other respects the Bank is neutral on the use of cash; that is, it aims neither to encourage nor to discourage it. In many parts of the world, plastic banknotes are beginning to take the place of paper notes, for instance, and the possibility of such a development in Iceland cannot be ruled out.

By law, the Central Bank of Iceland is the sole issuer of banknotes and coin in Iceland. The Bank prepares the issue of banknotes or coin bearing a new denomination, as in the case of the 10,000 kr. note, and has the coins minted or the banknotes printed upon receiving ministerial approval.

Preparation for the issuance of this note began in 2006, but work on the project was suspended in late 2008 and production of the note postponed. In 2011, however, the project was resumed because of the substantial work already done by designers, Central Bank staff, and the banknote manufacturer with which the Bank collaborates.

The banknote was designed by artist Kristín Þorkelsdóttir, who has directed the design of Icelandic banknotes since 1981. Her colleague and co-designer is Stephen Fairbairn.

The new notes were printed by De La Rue Plc. in the UK. De La Rue and its predecessors have handled banknote printing for Iceland for 83 years. The new banknote has already piqued the curiosity of central banks involved in the issuance of other, more prominent currencies. It features, for instance, a new multi-dimensional security feature called Optiks, which is designed to enhance its trustworthiness.

The note is dedicated to Jónas Hallgrímsson and contains various references to his work as poet, Icelandic scholar, essayist, and naturalist. And in commemoration of this event, later in today's programme, soprano Hanna Dóra Sturludóttir and pianist Anna Guðný Guðmundsdóttir will perform two songs composed to poems by Jónas.

I would like to take this opportunity to thank all those who have contributed their time and effort to bringing this new banknote into circulation: Central Bank staff, Government staff, and employees of Iceland's commercial and savings banks – and last, but certainly not least, designers Kristín Þorkelsdóttir and Stephen Fairbairn for their part in the successful design of Icelandic banknotes in recent decades.

I would now like to present Minister of Finance and Economic Affairs Bjarni Benediktsson with the 10,000 kr. banknote bearing the serial number 1, for inclusion in the numismatic collection.

I will now turn the podium over to the Minister of Finance and Economic Affairs, who is responsible on behalf of the Government for matters related to the Central Bank, and thereby for banknote issuance.