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Ásgeir Jónsson Governor of the Central Bank of Iceland. Speech at the 63rd Annual Meeting of the Bank April 4 2024

Madame Prime Minister, other Ministers, Chair of the Supervisory Board, and other honoured guests:

"The State cannot banish inflation by decree. It cannot order that prices shall be different than the principles of price formation dictate. Nor can it order federations of workers and employers to negotiate labour market agreements to please itself, or exonerate those groups of responsibility for unrealistic agreements. What the State can and must do, however, is to administer the functions under its purview with all due determination and steadfastness. These functions are the finances of the central government and its many institutions, monetary policy, and trade. If the State has sufficient control of its fiscal and monetary policy, and if it tenaciously pursues free foreign and domestic trade and exchange rate stability, both workers and employers will know on what grounds they can negotiate."

These were the words of Jónas Haralz in an article he wrote for the daily Morgunblaðið on 28 November 1979, which he entitled "Turning Point". He wrote the article to follow up a new economic policy proposal that had been introduced under the slogan "Blitzing Inflation" during the run-up to the Parliamentary elections that were to take place a week later. Jónas was the author of the policy, but not the slogan. The new policy entailed tackling inflation by rapid attack: liberalising interest rates, abolishing price controls in the domestic market, and halting depreciation of the króna, to name a

few features, while bringing government spending into line at the same time. The proposal was in the spirit of trends then gaining ground in the Western world. It is worth noting that it was around this time – August 1979 – that Paul Volcker was appointed Governor of the US Federal Reserve Bank. During Volcker's tenure, the policy interest rate in the US was hiked to 20%, which was enough to knock inflation down from nearly 15% to 3% in the space of only two years.

For most of the 1970s, inflation in Iceland ranged between 30% and 40%. Government leaders and Parliament spent an enormous amount of time on inflation-era measures, emergency legislation, amendments to terms and conditions, wage changes, and short-term economic actions that were supposed to exorcise the inflation demon, as was commonly said at the time. But it was all for nought. The inflation demon simply gained strength and steam. Inflation rose even further, hitting a historical peak of 60% in 1979.

On 10 October 1979, the Icelandic Government collapsed because of a lack of consensus on the economy. The Government led by Progressive Party leader Ólafur Jóhannesson had been in power for only one year. Its collapse came as no surprise to Kristján Eldjárn, Iceland's President. He was prepared to appoint an extraparliamentary cabinet under the leadership of Central Bank Governor Jóhannes Nordal. But at the last minute – on 12 October – the Independence Party agreed to withhold support for a no-confidence vote against the Social Democratic Party's minority Government until Parliamentary elections could be held in December.

This was the backdrop against which Jónas Haralz wrote the article called "Turning Point". To make a long story short, the elections proved to be no turning point at all. The new proposals did not gain support, as the slogan had been twisted from Blitzing Inflation to Blitzing Living Standards. There-

after, Jóhannes Nordal was called back to the presidential home at Bessastaðir to discuss a possible extraparliamentary cabinet, as he recounted in his autobiography, Lifað með öldinni [Living with the Century]. The cabinet was not appointed, however. The Social Democratic Party's minority Government held out for two more months, whereupon a new cabinet was formed under the leadership of Gunnar Thoroddsen in February 1980. The new Government's platform was quite conventional, and in fact, inflation kept soaring, reaching an annualised rate of 130% in the first half of 1983, well into the Thoroddsen cabinet's term in office.

Honoured guests:

A number of strategic decisions were taken in 1979 – decisions that affect us even today. It was then that the Minister of Fisheries issued a Regulation placing catch limitations on cod fishing, in the prelude to what we now know as the quota system. It was then that Parliament passed legislation on production controls in the agriculture sector, in the prelude to the quota system in that industry.

But what stands out most in my mind is that in 1979, price indexation of financial obligations was adopted in April with legislation known as Ólafur's Law. Prime Minister Ólafur Jóhannesson introduced the bill of legislation under his own name, as the cabinet did not support it unanimously. He said that he had drafted it himself at the kitchen table in his home and then walked down to Parliament with the completed document.

At that point in time, real interest rates on bank deposits were negative by 20%, meaning that in real terms, one-fifth of deposits were transferred from savings account owners to borrowers each year, effectively killing off any incentive to save money – to no one's surprise. At that time, powerful stake-

holders such as the leading corporate blocs in the country were profiting handsomely on negative real interest rates. The same was true of young people's mortgages and student loans: they simply burned up in the fires of inflation. The ones who lost on inflation were owners of deposits, who at that time were mostly older people. As a result, many people who had worked hard all their lives saw their life savings wiped out in just a few years. This transfer of wealth was probably one of the main causes of poverty among senior citizens later on. Ólafur's Law ensured that inflation would be impartial. It guaranteed that real interest rates would be low but positive, but without liberalising interest rates or resorting to painful consolidation measures to force inflation down. But the law changed Iceland's political landscape, as no one profited from inflation anymore. Measures to effectively tackle were finally taken but not until later.

To exorcise the inflation demon, it was necessary to interrupt the spiral of rising wages and a falling exchange rate and foster faith in price stability among the general public. The first step was taken in 1983, when a new Government under the leadership of Steingrímur Hermannsson discontinued the indexation of wages and then liberalised interest rates. With this, inflation quickly fell to between 20% and 30%. Nevertheless, price stability did not have the strong anchor it needed until 1989, when the exchange rate of the króna was pegged to a basket of currencies, interest rates were applied to dampen demand, and the practices used for labour market negotiations were reformed. Subsequently, it was agreed that the Government would stop financing its deficits with overdraft loans from the Central Bank, as it had done for a long period beforehand. Inflation dropped to single digits. But I won't go further into that story here.

Honoured guests:

The present situation is similar to that in the early 1970s in many ways. A new, labour-intensive industry – land-based freezing of fish – was introduced shortly after 1970, concurrent with the expansion of Iceland's territorial waters. GDP growth measured over 9% in 1972, as it did in 2022. Then, in 1973, an international energy crisis struck and there was a volcanic eruption on Heimaey, and some 5,000 people – perhaps more – found themselves looking for a new home. But what sets the two periods apart from one another is that in the 1970s, the Central Bank had neither the authority nor the independence to respond to inflation by tightening the monetary stance. The situation today, of course, is entirely different. The Central Bank was granted independence in 2001, and the inflation target was adopted at the same time. This brought with it a simple division of tasks: democratically elected representatives decided on an appropriate inflation rate and then empowered the Central Bank with implementing it. I view this division of labour as a key factor, not only for price stability but for political stability as well.

Nevertheless, monetary policy needs political support and prudent fiscal policy. Both Parliament and the Government must safeguard the Central Bank's independence and ensure that the Bank can perform the role entrusted to it by law.

Inflation targeting has been highly successful in countries with a long history of democracy, as the groundrules require transparency and public accountability, which are compatible with the groundrules of an open society. With amendments to the Central Bank Act that entered into force at the beginning of 2020, the Bank's responsibilities were expanded further. The Financial Supervisory Authority merged with the Central Bank of Iceland, and re-

sponsibility for financial stability and financial supervision were placed under the aegis of the merged institution, alongside price stability. These three functions support one another in the achievement of a stable economy and financial system.

The methodology entailed in inflation targeting – which prioritises clear ground rules, transparency, and public accountability – has been adapted to the Central Bank's other two key objectives: financial stability, and sound and secure financial activities.; i.e., financial supervision. In the main, decisions on the application of the Bank's policy instruments and the imposition of penalties are taken by three standing committees whose members include outside experts, thereby ensuring transparency and distribution of power. Transparency is the key to public trust and confidence. It means, among other things, that the Central Bank's financial supervisors take action where needed and their decisions are made public, so as to eliminate the suspicions and scepticism that could otherwise develop among other things. It is of vital importance to us all that we build up a sound and healthy financial market, no matter what role each of us may play in it.

The application of macroprudential tools can also support monetary policy by curbing lending growth and indebtedness in the economy. This has been done successfully in Iceland with the introduction of borrower-based measures. In the same manner, strong supervision limits risk-taking and bubble formation in the financial system and fosters greater resilience. The fruits of these efforts are clearly visible. The capital position of Iceland's systemically important banks is strong, and arrears are limited despite high interest rates, as households' and businesses' debt ratios have fallen in recent years and are low, both in historical context and in comparison with neighbouring countries.

Honoured guests:

Monetary policy is not the only thing that has changed in Iceland since 1979. Practices in the labour market are entirely different now. New comprehensive private market labour agreements with a term of four years were signed this March. The new contracts should ensure that a wage-price spiral will not develop. This alone makes them an important element in achieving lasting price stability. They were concluded in the belief that the Central Bank will perform its legally mandated role and ensure price stability – thereby safeguarding purchasing power – over the term of the contracts. In fact, it is stated explicitly in the contracts that they will be terminated if inflation is above 4.95% in August 2025.

Inflation now stands at 6.8% in terms of the twelve-month rise in the CPI. Thus it is still too far from the 2½% target. The current inflation episode stems from the overheating of the economy, which grew by nearly 20% in 2021, 2022, and 2023 combined – a rare occurrence in international context. Policy rate hikes have cooled this growth down, as figures show that domestic demand growth has eased. Even so, considerable pressures remain. The main source of concern, though, is that short- and long-term inflation expectations are still above the target. This gives rise to worries that the wage rises in the most recent labour market agreements will be passed through to prices. Added to this is an increase in Government expenditure, owing both to the wage agreements and to the seismic activity near Grindavík, which means that up to 1% of the country's population must now look for new housing.

The Central Bank is obliged to ensure that inflation converges with the target within an acceptable time frame. Otherwise, the risk is that the wage agreements will not deliver the expected purchasing power. This is why it

was not a given that the policy rate would be lowered as soon as the ink dried on the contracts. On the contrary: untimely interest rate cuts could impede the disinflation process and result in the termination of the wage agreements. And to quote from the Monetary Policy Committee's most recent minutes, published yesterday, "Unambiguous indications that inflation was clearly on the decline would have to emerge in order to make it possible to lower interest rates, and it was important to begin the monetary easing phase at a credible point in time."

We Icelanders cannot enjoy substantially stronger GDP growth and larger pay rises than other countries do, and yet still have the same interest rates and inflation that they do – it is simply impossible. In most other European countries, the problem is more acute: persistent inflation and limited or even negative output growth.

Although many have criticised the Central Bank roundly for having hiked the policy rate up to 9.25% in response to this overheating and inflation spike, I can assure you that the repercussions would have been far worse if the Bank had not responded. That would have been a journey back to the past, and one that few of us would have chosen to take.

Individuals come and go, but the strong framework that has been created for monetary policy and the application of that policy by the legislature and the Central Bank should produce results comparable to those achieved by other inflation-targeting countries. We will get results, but only if we are steadfast and disciplined and if all of us abide by the groundrules of the policy structure we have chosen.

Honoured guests:

In 2013, the Central Bank embarked on a systematic programme of foreign currency purchases in order to keep the króna from overshooting in the wake of the tourism boom, but also to build up non-borrowed reserves. The purchase programme remained in place until 2017. Over that period, the Bank bought 6.1 billion euros, the equivalent of 838 b.kr. It has always been considered wise for farmers to make hay while the sun shines, ensuring that they will have ample supplies to see them through hard times. This principle proved its worth during the COVID-19 pandemic, when tourism industry revenues more or less dried up overnight in March 2020 and the króna began to depreciate. The Central Bank responded and, in 2020 and 2021, sold currency equivalent of 965 million euros, or 155 b.kr. in the foreign exchange market to support the króna and ensure price stability. But abundant international reserves are also important even if they lie untouched. In this case, the Biblical text about how faith can move mountains is very apt. As an example, we can take what happened during the pandemic – or more precisely, what did not happen during the pandemic: There was no capital flight from the Icelandic króna, even though exports shrank by over 30%, the largest single-year contraction in exports in the history of Iceland's modern national accounts. The fact that there was no capital flight is doubtless due in large part to Iceland's large international reserves and sound economic policy.

Abundant reserves are important not only for the credibility of the Central Bank, but also for the credibility of the entire Icelandic financial system. This can be seen in the terms offered to Icelandic firms and the Icelandic Government in international credit markets, for instance, and in statements issued by credit rating agencies and international institutions.

When the Central Bank buys foreign currency in the interbank market, it pays in Icelandic krónur. All else being equal, this is equivalent to injecting liquidity into the financial system. As a result, it was necessary to sterilise the intervention in the foreign exchange market by, among other things, offering the banks the option of holding liquid assets in the Central Bank as deposits. In previous years, the Bank's policy interest rate was defined as the rate on collateralised seven-day loans. The reverse is now true. The policy rate, or key interest rate, is now the rate on seven-day term deposits with the Bank.

The experience of recent years has shown that using the deposit rate as a policy instrument has resulted in very effective transmission of monetary policy to the real economy. The problem is, though, that the application of monetary policy has changed: instead of being an income-generating function for the Central Bank, as it was when the Bank earned interest on loans to banking institutions, it is an expense item because the Bank must now pay high deposit interest to financial institutions and the Treasury. To be sure, the Central Bank does have foreign assets – mostly foreign bank deposits or foreign government bonds – and earns interest on them. But the interest rate on those assets is far below the rate the Bank must pay on króna-denominated deposits.

In 2023, the Bank's interest balance was negative by 9.4 b.kr. Actually, it has been negative every year since 2015, apart from 2020, when the policy rate was historically low. Although central banks are not profit-driven and, technically speaking, cannot become insolvent in their home currency, their financial position does affect their credibility. Sometimes central banks' capital has been viewed as a standard for the value of the currency they issue. But in any event, it is clear that operating a central bank at a loss entails a

transfer of wealth into the economy. It is because of this that there are accepted international benchmarks emphasising that central banks should preserve their capital – partly to ensure credibility. The Central Bank of Iceland's capital target, endorsed by the Supervisory Board by law, is 150 b.kr., but at the end of 2023 the Bank's capital was 101 b.kr. By the end of Q1/2024, it had fallen to 95 b.kr., which puts it 55 b.kr. below the target.

The Central Bank of Iceland is not alone in operating at a loss. Most, if not all, Western central banks currently have negative interest rate differentials, the result of large-scale quantitative easing (QE) during the aftermath of the 2008 financial crisis. QE entails that central banks print money by buying government bonds, and even corporate bonds and equities. The QE policy was prevalent for about a decade, and now most leading central banks are left with bloated asset portfolios that have tumbled in value since interest rates started rising. Efforts to unwind these asset portfolios must be undertaken with care in order not to destabilize markets into utter disarray. The excess of liquidity prevailing in most Western countries has caused the central banks concerned to mop up liquidity by offering deposit accounts. This is very costly.

In the recent past, central banks have adopted a range of measures to strengthen their capital position. These include capital injections from the government, increased non-remunerated reserve requirements, special levies on deposit institutions, and reductions in interest payments to the government. In Sweden, new legislation on Sveriges Riksbank states that the bank shall call in capital from the government if its capital falls below a specified minimum, so that the bank will not end up in a persistent negative capital position, as it did in 2022. The Bank of England decided recently to introduce an annual levy on deposit institutions to cover the cost of its own

policy functions. This takes time and requires statutory amendment. The European Central Bank and the Norwegian one have lowered interest rates on government deposits and increased their reserve requirements. In addition, the European Central Bank has lowered the interest rate on required reserves to 0%.

The Central Bank of Iceland must take comparable measures in order to improve its interest balance, and it must review the interest rates it offers to counterparties such as the Treasury and deposit institutions, with the aim of better distributing the cost associated with running independent monetary policy and ensuring sustainable financing of Iceland's international reserves.

In a statement issued this morning, the Monetary Policy Committee announced that it has decided to increase credit institutions' fixed non-remunerated reserve requirement from 2% to 3% of the reserve base. In the MPC statement, it is said that "the short-term effects of the change should be limited. In the longer term, however, it will provide a more solid foundation for monetary policy conduct, thereby enhancing the Central Bank's credibility and promoting more effective monetary policy."

To put this into context, the Central Bank paid financial institutions roughly 20 b.kr. in interest on their deposits in 2023. The need for these measures should therefore be obvious.

Honoured guests:

I began my speech today with a blast from the past – from 1979, to be specific. As I was born in 1970, I was a strapping lad of nine in that momentous year. My father was a farmer at Bjarnarhöfn and a regular reader of the newspaper Þjóðviljinn. My grandfather lived next door and read Tíminn.

They did not discuss politics nor swap newspapers, though; each one read his own. I read both. But I never saw Alþýðublaðið or Morgunblaðið. Perhaps I internalised a skewed picture of events, but in my memory it seems as though the economy was in a perpetual state of emergency: continuous income cuts, emergency legislation, index adjustments, and so forth. The words "chaos" and "disintegration " are the ones that come to mind.

Ever since I became Governor of the Central Bank forty years later – in 2019 – it has been my goal to get beyond Ólafur's Law, so to speak. By this I mean that I want Iceland to build up a nominal interest rate system like that in other countries. There are many reasons why broad-based price indexation creates problems for monetary policy and for the financial system as a whole, but that discussion is too long for today. Nevertheless, I would like to quote a report called Nauðsyn eða val? [Necessity or choice?], issued in 2012 by Finance Iceland, then known as the Icelandic Financial Services Association. I should also mention that I was one of the authors of the report. The part I wish to highlight reads as follows:

"Just as the passage of Ólafur's Law ensured that no one profited anymore on inflation through negative real interest rates, and thereby created the political will to adopt realistic measures to bring inflation down, variable interest rates could raise the public consciousness about the cost of inflation, thus fostering an institutional commitment to price stability that has been sorely lacking in Iceland."

This seems to me to be a prophecy that has come to pass. Since mortgages with variable nominal interest rates became common in Iceland after 2020, public discourse on inflation has undergone a sea change. The fight against inflation is now a societal priority, as can be seen in the discussions and framework for the most recent wage agreements, as well as in political dis-

course. This is what is referred to in the citation as an institutional commitment. That commitment has developed because with variable interest rates, inflation is paid up front. Inflation comes to the fore in higher debt service, but at the same time, the loan principal declines quickly in real terms and the borrower builds up equity. This is what is meant by "raising consciousness about the cost of inflation." The reverse is true with indexed loans, where debt service remains relatively stable but inflation is added to the principal, eroding the borrower's equity position.

I also want to stress that while policy rate hikes have increased the debt service burden on non-indexed loans, the inflation shock has not hit those loans as hard as it would have if those loans had been indexed. This is particularly the case for borrowers who took loans with fixed-rate clauses and have benefited from negative real interest rates – the first time this has happened since 1979. Of course, it is impossible to maintain a nominal interest rate system with negative real rates over a long period of time in an environment of free price formation. Low inflation is therefore a prerequisite if variable nominal interest rates are to be viable as a loan form. The Central Bank raised its policy rate in response to soaring inflation. It will lower it again when inflation eases.

And we are on the right path. Inflation is indeed falling, albeit more slowly than we would have wished. I would like to reiterate that at the same time, the Central Bank has been able to promote good general stability in the financial system and the economy, despite an enormously overheated real economy. Strong GDP growth has not been driven by debt or by credit growth, and in real terms, households' and businesses' debt levels have actually fallen in the recent past. Iceland's balance of payments is stable, and the currency has been stable and supported by a current account surplus.

I am optimistic by nature, and I hope we can manage a soft landing for the economy, but that requires that we play our cards intelligently.

I would like to end where I began – by quoting from Jónas Haralz "Turning Point".

"Inflation will be a problem in all free societies for the foreseeable future. Keeping it in check will require constant vigilance and drive. People cannot conquer inflation once and for all, any more than they can manage their own lives responsibly once and for all. The other idea is that the battle with inflation will be painless because it is quick. This is equally far from the truth. Inflation cannot be contained without pain and sacrifice, no matter whether attempts are made to speed up the process or drag it out. But the rewards for the pain and sacrifice are many times greater if progress is made."

And finally, I would like to mention that Gudrún Thorleifsdóttir stepped down from the Financial Supervision Committee earlier this year. I want to thank her for her valuable cooperation and welcome her replacement, Erna Hjaltested.

Thank you for listening.