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Address

Ásgeir Jónsson, Governor
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On 19 October 1918, Iceland finally reached a sovereignty agreement with the Danish authorities. But that day, 19 October, was momentous for another reason as well. It was the day the second wave of the Spanish flu arrived in Iceland with the passenger ship *Botnia*. No hygienic measures or mitigating actions were taken at first. In fact, the Surgeon General considered it pointless. The disease spread like wildfire and peaked a mere three weeks after it had been borne to Iceland. However, the authorities prevented the spread of the Spanish flu to North and East Iceland by closing off transportation. At that time, half of the nation lived in the countryside, and it was therefore easier to maintain distances between people than it is today.

Iceland recorded its first death from the Spanish flu on 2 November 1918. An estimated 63% of Reykjavík residents were infected, and around 500 Icelanders died, making for a mortality rate of 2.6%. The Spanish flu hit young people the hardest. It is clear that, against this backdrop, the celebration of Iceland's sovereignty, when the Danish-Icelandic Act of Union entered into effect on 1 December 1918, was a bittersweet affair.

But misfortune had more in store for Iceland. The armistice ending World War I took effect on 11 November 1918. This undeniably joyous event was followed by a deep economic recession. In autumn 1919 came the Great Crash, when the price of Iceland's most important export product – salted herring – collapsed. As the winter advanced, Iceland became virtually unable to sell its fish. Foreign exchange revenues stopped flowing into the country. It was in late summer 1920, when the Prime Minister of Iceland was in Copenhagen intending to pay some outstanding debts, that Danish banks refused to accept the proffered mail order cheque issued by Íslandsbanki, which functioned at the time as Iceland's central bank. Iceland had no foreign currency and had to ration goods the following winter. The economy took a nosedive – one that turned out blessedly short-lived. The years to follow brought major improvements, until the Great Depression in the 1930s. But that is yet another story.

Honoured guests:

American author and satirist Mark Twain is quoted as saying “History doesn't repeat itself, but it often rhymes” – just like a good Icelandic quatrain. Now, a century after achieving sovereignty, we Icelanders are facing many of the same challenges as in autumn 1918. But with one major difference: in 1918 the country was destitute and unprepared – with the authority of a sovereign but without social infrastructure such as a healthcare system. Today we are in a vastly different position. We are prepared, and we have the capacity to meet the shock sweeping the country head-on – and then, before too long, we will turn defence into offence once again.

Since the onset of the Great Recession in 2008, we have rebuilt a new financial and monetary system designed precisely to withstand headwinds like those we are facing today.

We have built a banking system that is funded almost entirely with domestic savings, with a capital adequacy ratio of 25%, and with abundant liquidity.

We have also built up a new export-driven economy where both businesses and households have a strong equity position, and where strong national saving is reflected in a large and sustained current account surplus. For the first time in Iceland’s modern history, its international investment position is positive; i.e., our foreign assets exceed our foreign liabilities.

We have also enjoyed stability and robust GDP growth for the past seven years, with GDP increasing by a third and real wages up 35%. Iceland is now among the wealthiest countries in the world in terms of GDP per capita.

We are prepared – and now we must face the challenge firmly, calmly, and stoically.

Honoured guests:

One of the things that were not done during the prelude to Iceland’s sovereignty was the establishment of an independent central bank. It wasn’t until 1961 that the Central Bank of Iceland formally began operation, and at that time it was not nearly as independent as it is today. Many of the economic policy problems Icelanders dealt with in the first 100 years of its monetary independence stemmed precisely from the lack of an independent central bank with full scope for policy action. In essence, Iceland lacked the institutional architecture required to maintain economic stability.

And even in 2001, when the Central Bank of Iceland was formally granted independence in order to maintain price stability through inflation-targeting, only half the battle was won. The Bank had neither the authority nor adequate tools to ensure financial stability.

But fortunately, this has changed.

I stand here as the head of a new Central Bank created by the merger with the Financial Supervisory Authority, which took effect on 1 January 2020 – a Central Bank with explicit authorisations and a vast range of tools at its disposal to ensure both price stability and financial stability through measures focusing on monetary policy, macroprudential policy, and financial supervision. Although barely three months have passed since the merger took effect, it has already demonstrated its value. We, the employees of the new Bank, have been able to respond, swiftly and in a coordinated manner, to the threat posed by the COVID-19 pandemic.

The application of the Bank's policy instruments is in the hands of three committees comprising both internal and external members, which take decisions jointly by majority vote. These committees – the Monetary Policy Committee, the Financial Stability Committee, and the Financial Supervision Committee – have clearly defined objectives, as well as policy instruments to achieve them. They take independent decisions that they must account for publicly. This arrangement ensures both transparency and distribution of power. In addition, three Deputy Governors have taken office – in the fields of monetary policy, financial stability, and financial supervision – in order to ensure even more fully that the authority for decisions on application of policy instruments is distributed effectively.

There has been complete consensus among us four Governors, as well as the other members of the Bank's three committee, in our support of the measures taken in response to the COVID-19 threat, and we have met at very short notice to discuss and approve measures when necessary. The Central Bank of Iceland stands together as a cohesive and united whole in the tasks that lie ahead.

Unlike many other Western central banks, the Central Bank of Iceland has considerable scope for policy action, as interest rates here are higher than in many other economies and the capital requirements made of the banks are much more stringent than they are elsewhere. And we have used the scope this has provided us.

In the past two weeks, the Bank has lowered interest rates by a full percentage point. Its key rate is now 1.75%, and we can lower it still further. We have lowered the banks' liquidity reserve requirements, easing their liquidity position by 40 b.kr. We are ready to inject more liquidity into the system if the need arises.

Furthermore, we have lifted the 2% countercyclical capital buffer on financial institutions. The buffer has been reset to 0% and will remain there for at least the next two years. Lifting the countercyclical capital buffer requirement will make it easier for the banking system to support households and businesses by creating the scope for new lending in an amount ranging up to 350 b.kr., or 12.5% of the current loan portfolio, all else being equal.

Moreover, it was decided this past Sunday, at an extraordinary meeting of the Monetary Policy Committee, to begin direct purchases of Treasury bonds in the secondary market. This will both support fiscal policy and ensure that lower interest rates are transmitted out the entire yield curve, thereby lowering households' and businesses' financing costs, which is the Bank's objective.

Honoured guests:

In Iceland's campaign for independence, currency issues were never mentioned. It was automatically assumed that Iceland would continue to participate in the Nordic currency union as an independent member, as the Norwegians had done after separating from Sweden in 1905. Participation in Nordic currency cooperation was actually written into the agreement made when Iceland was granted sovereignty in 1918. This currency cooperation was based on the gold standard, as were most of the world's currencies at that time. However, the Nordic currency union fell apart during the post-war years, and Icelanders were forced to rely on themselves as they endured the shocks that pummelled the country during its first years of sovereignty. And we've been on our own ever since.

Iceland has a number of unique characteristics that complicate economic policy. The economy is extremely small. Its export sectors are homogeneous and prone to cyclical fluctuations. Most of its financial markets are relatively shallow and illiquid, which complicates price formation. Not only is our currency small, it is also bordered on both sides by two of the largest currency areas in the world – which cannot but make independent monetary policy conduct more difficult. And there are other factors as well. Icelanders demonstrate a decided herd mentality in their consumption decisions, which causes wide fluctuations in private consumption. With its small population, Iceland has a limited number of workers to do all that is needed – operate the healthcare, education, and administrative systems – and conduct monetary policy as well.

Anyone discussing Iceland's monetary policy concerns is bound to acknowledge these problems. On the other hand, it is clear that the greatest problems facing domestic monetary policy do not stem from the structural flaws inherent in Iceland's history and geographical characteristics – flaws that are unlikely to change. The biggest problems are institutional, political, and – perhaps most of all – societal: They centre on fiscal policy decisions, collective bargaining agreements, and overall societal consensus. These we can change.

The marvellous thing about Icelanders is that we have never let trivial matters like population undermine our steadfast belief that we can stand shoulder-to-shoulder with other countries in everything that we endeavour to do – if we only take the matter seriously enough. This is the attitude that we should take towards economic policy. In this context, I agree with Icelandic independence leader Jón Sigurðsson when he warned about Icelandic individualism, saying, "Many tend to think of Iceland as being alone in the world and deny that other countries' experience matters."

It is never stressed often enough or loudly enough that monetary policy is social welfare policy. Economic volatility generally leads to unexpected changes in people's personal situation – particularly for people with low income. The cost of inflation is more onerous for low-income people and causes purchasing power to fluctuate.

Successful economic policy reduces the level of uncertainty in people's everyday lives, and price stability delivers increased purchasing power and a predictable housing market. Economic stability is a normal and appropriate thing for people to demand – and the principal objective of the Central Bank of Iceland.

Successful monetary policy is therefore extremely important for general well-being and reduces the likelihood of poverty, while economic policy mistakes are costly, not least for those with the lowest income. Increased credibility of monetary policy leads to lower interest rates, thereby improving debtors' situation. It is therefore of vital importance that we agree as a society to maintain economic stability through thick and thin.

Honoured guests:

Influenza epidemics are nothing new. In the past 500 years or so, there have been about two to three influenza pandemics per century. It is likely that no one remembers the Asian flu of 1957 or the Hong Kong flu of 1968 any longer. But these were deadly pandemics that took place in the twentieth century, even though they paled in comparison with the Spanish flu, which killed between 21 million and 50 million people worldwide.

What is unique about COVID-19 is not the illness itself but the response to it. The disease control measures adopted around the world are unparalleled. They come at an enormous economic cost and could easily bring with them a deep, but hopefully short-lived, economic recession. Lost output and income are a price we are prepared to pay to save lives.

I consider it extremely important that we Icelanders remember this first, before we yield to the temptation to whine, turn pessimistic, and pity ourselves. We must all make sacrifices that will hopefully save lives, but no rescue package from the Government can mitigate the inconvenience except to a very limited degree.

As I mentioned before, the Financial Supervisory Authority and the Central Bank merged at the beginning of this year. Although a great deal of work on merging and integrating our operations lies ahead, our unified institution has begun the year well. The disturbances caused by the COVID-19 pandemic will inevitably delay many streamlining and integration measures, however.

Nevertheless, merging the tasks of the Central Bank and the Financial Supervisory Authority into a single institution better enables us to face shocks like the current one and rise quickly and decisively from the downturn that lies ahead.

I am convinced that, under these circumstances, the incontrovertible mathematical formula – that 1+1=2 – does not apply. The strength of the two institutions unified will be much greater than the sum of its parts.

The new Central Bank is an institution that dares to act, can act, and will act. Although a number of policy actions have been taken in recent weeks, we have not emptied our toolbox – far from it. We have a number of other economic policy measures available and will use them if and when the need arises. We will do what is needed to face down the deep but brief economic shock currently threatening our country.

Honoured guests:

We thank you for listening.