

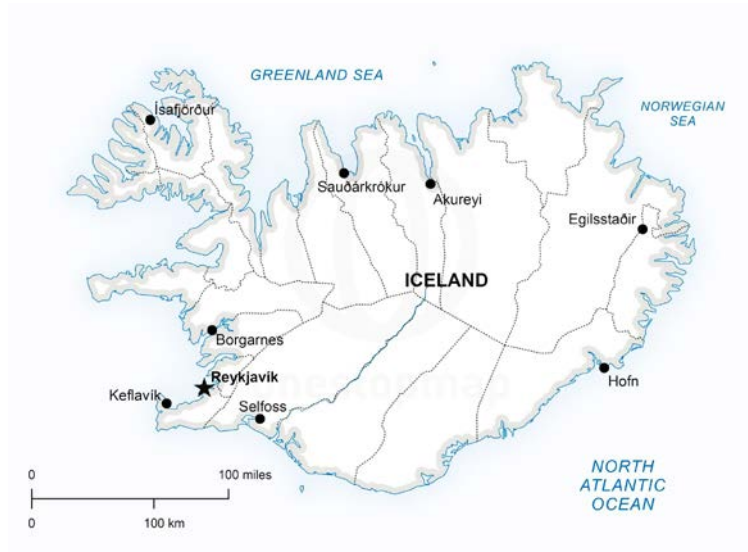


Lessons for Iceland from the monetary policy of Sweden

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Iceland and Sweden a comparison



Population: 330 000
GDP: 17 billion USD (2016)
Exports: 48% of GDP
Inflation: 2%
Currency: Króna (ISK)
Monetary policy: inflation target.
Volatile monetary history (99 %
depreciation since 1922)



Population: 10 000 000
GDP: 485 billion USD (2016)
Exports: 44% of GDP
Inflation: 2%
Currency: Krona (SEK)
Monetary policy: inflation target.
Regular changes in policy regime (10
regimes since 1922)

Swedish monetary policy



Inflation target

- Adopted in 1993
- 2% +/-1 percentage point

More than monetary policy rules

- Fiscal policy rules
- Labour market rules

Is inflation targeting a success?

Comparison with previous regimes

* Price stability



* Fiscal stability



* Trust in policy



* Exchange rate stability



* Real economic stability



* Financial stability

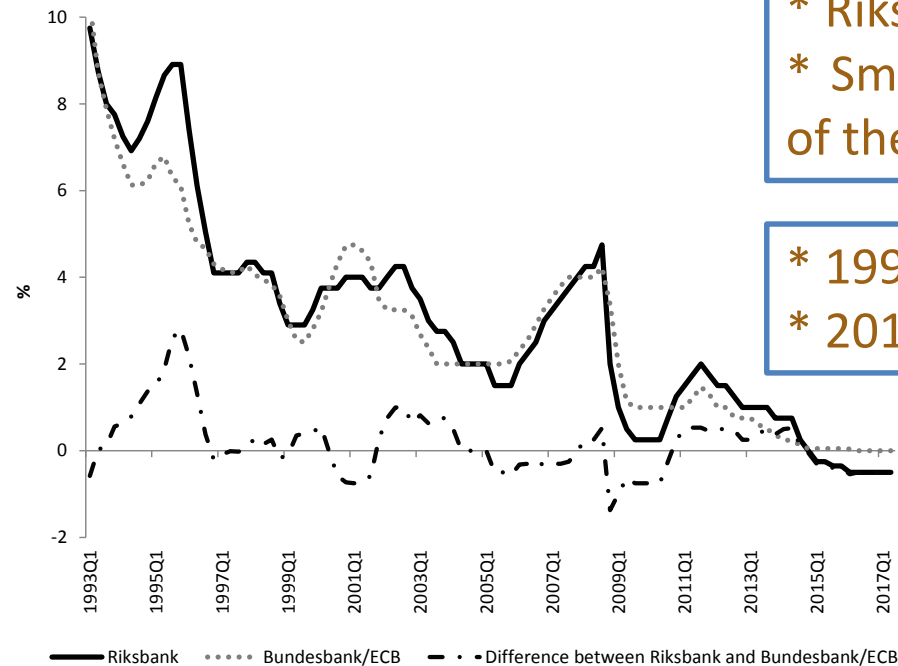


* Policy makers and labour market participants have kept to the rules of the inflation target.
* Greater price stability and trust in economic policy.

* Increased real economic volatility
* Growing financial imbalances

International dependence

Riksbank is shadowing the ECB



* Riksbank is shadowing the policy of the ECB.

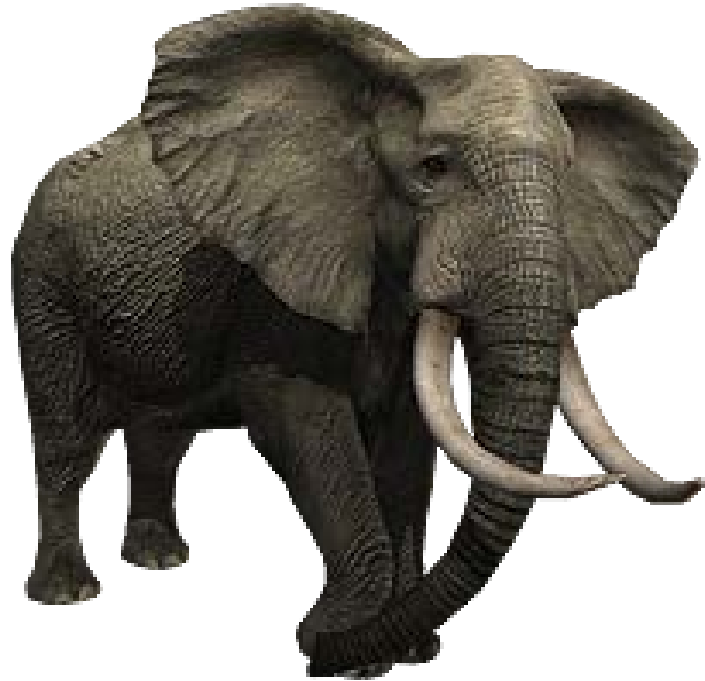
* Small deviations cause large variations in the exchange rate of the krona (SEK).

* 1997 – 2008: business cycle synchronisation

* 2011 – 2018: financial integration

International dependence

Riksbank is shadowing the ECB



Stefan Ingves governor of the Swedish Riksbank:

"Our neighbour is an elephant. When it moves it affects us".

Swedish economy in 2018

- * Best labour market since 1980s
- * Highest growth since the 1990s
- * Credit and housing boom. Highest debt and prices ever.
- * Expansionary monetary policy and record low exchange rate for the krona (SEK).

Monetary policy 2011-2017: crisis policy without a crisis due to international dependence.



Swedish monetary policy. Summary

Rules based (monetary, fiscal, and labour market): inflation target. Rules are followed.

Inflation stability but not real economic, exchange rate or financial stability.

Free capital flows makes it difficult to be monetary policy independent. The Riksbank is shadowing the elephant (the ECB).

Crisis policy without a crisis is now causing growing imbalances.



Iceland. 100 years of political independence. Which monetary system for the next 100 years?



Fögnum 100 ára fullveldi Íslands
100 árs suverænitet i Island
100 years of sovereignty in Iceland



Possible exchange-rate arrangements for Iceland, that is the króna (ISK)

No optimal policy regime exists for all times and for all countries: Characteristics of the economy matter. Iceland is an extremely small economy with a volatile monetary history. 99 % depreciation

Fixed exchange rate

- A1. Truly fixed rates: a monetary union with a common currency (euro area)
- A2. Fixed rate, adjustment possible but difficult: currency board (e.g., Hong Kong, Estonia, Bulgaria and Lithuania)
- A3. Fixed, adjustment possible but difficult: commodity money (e.g., gold, silver)
- A4. Fixed but adjustable (pegged rate): fixed exchange rate vs other currency or basket or currencies (e.g., Bretton Woods, ERM)

Floating exchange rate

- B1. Rules-based systems: inflation targeting (Sweden, UK, euro area), monetary targeting
- B2. Rules-based systems: multiple goals (inflation, employment) (United States)(Bundesbank pre-1999)
- B3. Discretionary systems: no fixed rules



The trilemma vs the dilemma

Trilemma (old)

Choose *two* of the following three:

Fixed exchange rate – free capital mobility – monetary independence

Dilemma (new) due to close financial integration

Choose between:

Free capital mobility but no monetary independence

or

Capital controls and monetary independence



Capital controls?

No: Iceland is too small.

Closed capital markets would likely reduce economic growth in the long run.

Political economy of capital controls rejects the use of controls.

(Capital controls invite political corruption and evasion)



Fixed or floating?

No capital controls \Rightarrow no independent monetary policy \Rightarrow fixed exchange rate

Iceland tried inflation targeting. Major contribution to the great financial crash of 2008.

Inflation targeting does not provide monetary and financial stability in the future for an economy as small as that of Iceland.

Flexible exchange rate not always a shock absorber. Sometimes shock amplifier.

Which fixed exchange rate arrangement for the ISK?

- * Fixed but adjustable (pegged rates)?
- * Currency board?
- * Monetary union?



A currency board for Iceland!

Fixed but adjustable rate: invites speculative attacks, Iceland have tried this regime. It has failed.

Monetary union: no escape clause (or a very expensive one). Iceland rejects EU membership for the moment. Thus Iceland cannot join the euro area in the foreseeable future.

Currency board: more stable than fixed but adjustable exchange rate. Includes an escape clause.

Has proven stable, delivering monetary stability. Estonia, Lithuania, Bulgaria in Europe. Hong Kong and Singapore in Asia.

A currency board for Iceland!

Positive: stability, rules-based, escape clause, well-tested. A currency board gives instant monetary credibility. Icelandic interest rates will be (almost) identical to euro rates.

Negative: no monetary autonomy, in case of large asymmetric shocks no lender of last resort.

A currency board for Iceland should be combined with other measures:

- Stabilization funds to buffer against real economic shocks (fishing, tourism, aluminium)
- Capital restrictions on commercial banks (to limit risk of financial crisis)
- Fiscal policy rules (supporting the currency board)
- Labour market flexibility (labour unions must accept the rules of behavior implied by the currency board).



Major advantages of a currency board for Iceland

Keep the national currency the króna. Fostering national identity.

Instant monetary stability and credibility.

The króna has depreciated sharply during the past 100 years – 99.95 procent.

For the next century Iceland should have a monetary system that delivers exchange rate stability and price stability and thus a more stable domestic economy, inducing growth and political stability.





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