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Requiem for a Currency?

BY JONAS MOODY PHOTO BY PÁLL STEFÁNSSON

Last year Iceland was thrown into the international limelight when concerns arose over the country's economic stability. Although the bulk of foreign analysts' qualms have been quelled, some Icelandic companies are taking measures to sidestep one of the nation's perceived wobbly legs: the Icelandic króna. Arnór Sighvatsson, chief economist of the Central Bank of Iceland, spoke out last year claiming that the benefits of holding on to an independent currency were next to nothing. In this interview, Arnór explains his take on the currency, Iceland's monetary policy, and the fate of the only Icelandic crown the country has ever known.

Jonas Moody: What sort of impact has the Icelandic króna made on the country in recent years, specifically the economy and Icelandic business?

Arnór Sighvatsson: The strong króna in 2004 and 2005 helped contain inflationary pressures brought about by the large investment projects and financial market liberalization, but the sharp depreciation in the first half of 2006 was premature and unwelcome. Icelandic firms have managed this volatility in the króna quite well so far, but in the long run it may affect export growth negatively if it persists.

JM: How do you respond to some Icelandic companies changing their operational currencies out of the króna and paying portions of their salaries for Icelandic employees in foreign currencies?

AS: I think the implications for the conduct of monetary policy have been exaggerated. Monetary policy has been run successfully in countries with a higher degree of dollarization (or rather *euroization*) than Iceland. For the bulk of Icelandic employees it would seem risky to accept a large share of their compensation in the form of foreign currency as long as most of their expenditures are ISK denominated. Full-scale *euroization* would only occur in the case of some very low probability event like hyperinflation. I see no chance of that.

JM: Dostoevsky once said, "Money is coined liberty." While he wasn't necessarily referring to national liberty, the right to print a national currency has long been associated with a nation's independence. Do you think the króna is a symbol of Icelandic independence?

AS: With the advent of globalization and the removal of trade barriers, the monetary border has become as leaky as the one along the Rio Grande. It is probably right that the Icelandic króna was originally mainly a symbol of independence. However, Icelandic policymakers have never been able to make up their minds whether the basic goal of exchange rate policy was to serve as a monetary anchor or a means of macroeconomic adjustment. If the exchange rate solely serves the function of a monetary anchor, national currency becomes a mere symbol, as in the case of Denmark for example.

JM: So would Iceland be sacrificing some degree of its sovereignty by relinquishing its currency?

AS: Since 2001 the monetary policy framework has been defined in terms of an inflation target to be obtained by an independent central bank. This policy relinquishes sovereignty to a domestic rather than foreign central bank. As the mandate of the Central Bank of Iceland is highly technical in nature, voters probably should not care whether a domestic or foreign central delivers the public good of price stability. The question is which does it better and at a lower cost. Our record so far certainly leaves some room for improvement, but the jury is still out.

JM: Last year you claimed that the benefits of Iceland holding onto its independent currency were next to nothing. Do you still stand by this statement, and if so, what can be done to rectify the situation?

AS: It is unrealistic to assume that a floating exchange rate will serve as a shock absorber in the case of Iceland. To reduce exchange rate volatility further we need all the help we can possibly get from the government, the labor market participants and others. That way we can live with a floating króna without excessive costs, and the prospect is that it we will have to do that for considerable time. Running an independent currency for a very small economy, however, will never be cost-free. If that were the case, returning to barter trade would probably not be that costly either. The value of money depends on how widely it is accepted.

JM: There seems to be an age-old conflict in Iceland between holding onto tradition and looking to the future. Is this the question facing the country today with regard to the króna?

AS: Exchange rate policy has been in flux ever since the króna came into existence. How long we keep the króna will be decided by political factors more than economics. There is always some reluctance to give up what you have for something of untested quality.