ISK or euro – not both!

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Road map

- The facts
- Major *problems with further gradual, partial financial euroisation*
- Alternatives
  - Accede to EU, then enter EMU – a primarily *political decision*, won’t discuss this
  - Try to put EMU in framework of EEA – *unrealistic* (Maastricht Treaty does not allow representation on the ECB Board for any non-EU members)
  - Active de-euroisation policy (*how?*)
  - *Unilateral euroisation*

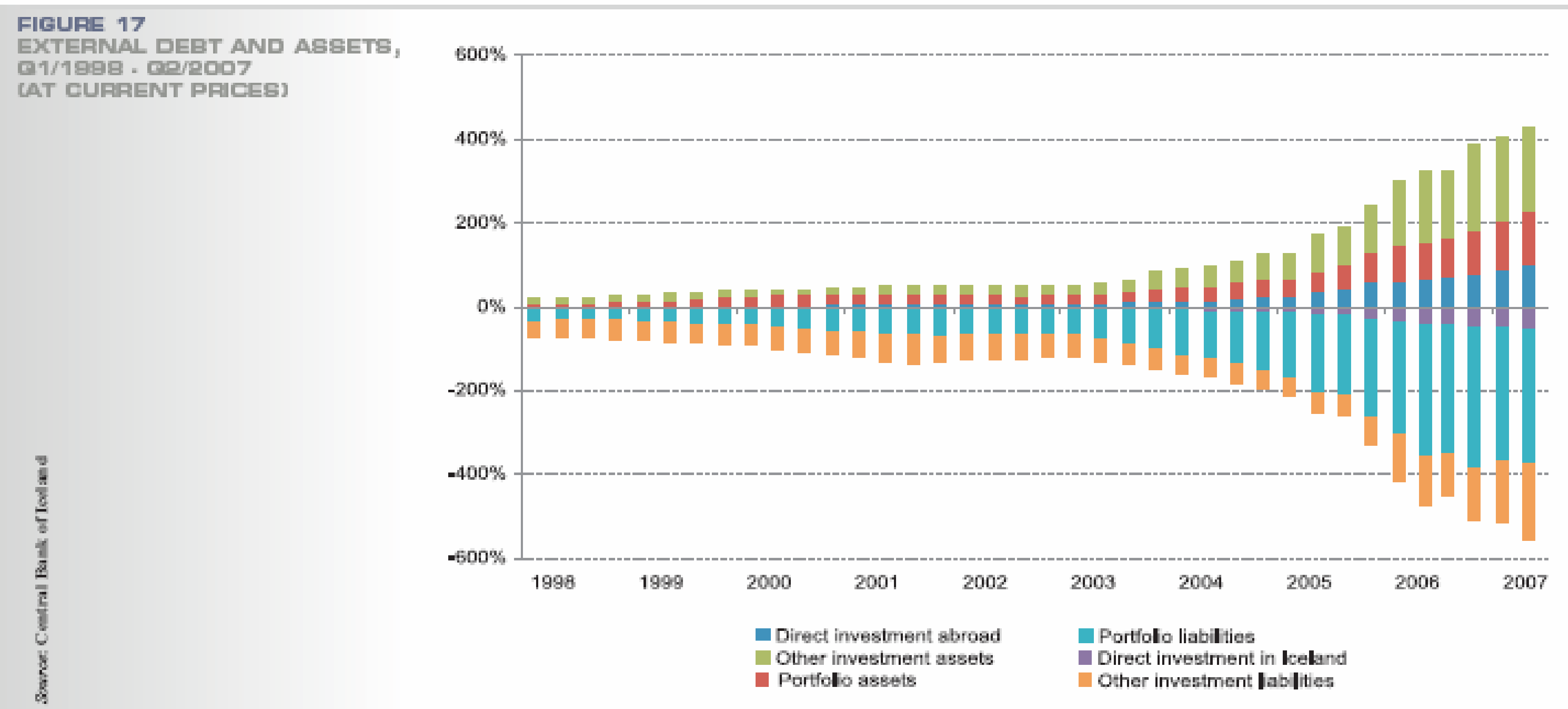
The facts

- No currency substitution (yet)
- But significant *de facto* financial euroisation: asset (and liability) substitution
- Not clear why – standard stories of ‘financial dollarisation’ don’t fit Iceland – process rather different here, based on internationalisation of big banks and some major non-financial companies
- But it’s unlikely to stop spontaneously

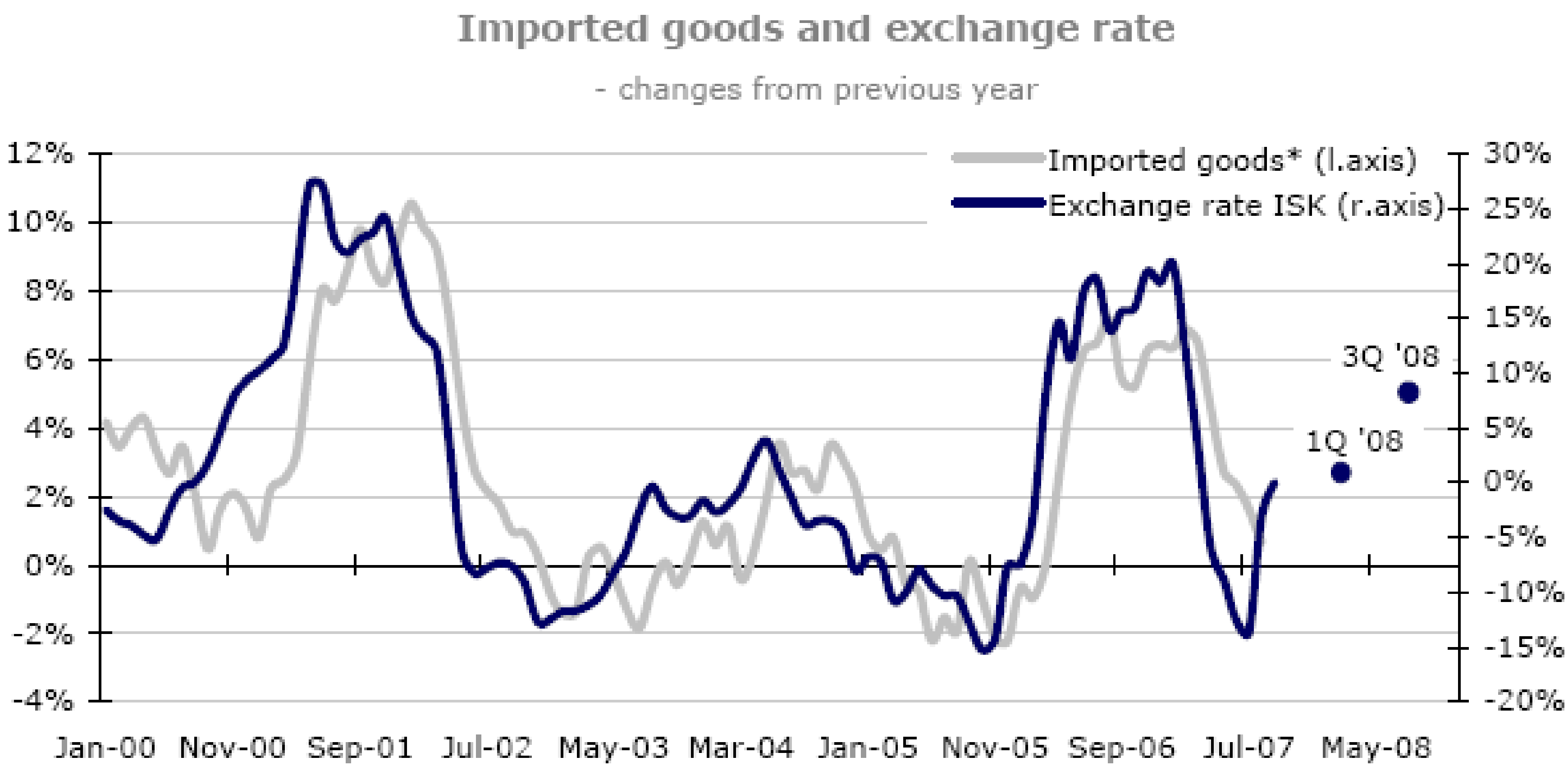
Key data

- Economy not exceptionally open in *trade* (trade participation ratio = 40%)
- 52% of trade is with euro area plus Denmark
- Uniquely open *financially*: external liabilities > 500% of GDP, external assets > 400% of GDP
- **Very high**
  - *exchange rate ‘passthrough’* into prices (only Israel and Estonia higher among small open economies)
  - *equity market volatility* (related to exchange-rate volatility)
  - *GDP volatility* relative to export volatility
  - *real interest rates*
  - *carry trade*

External debt and assets (% of GDP)



Exchange-rate passthrough



*Corrected for impact of tax-cuts

Sources: Kaupthing Research, Statistics Iceland

Exchange-rate volatility exacerbates equity market volatility

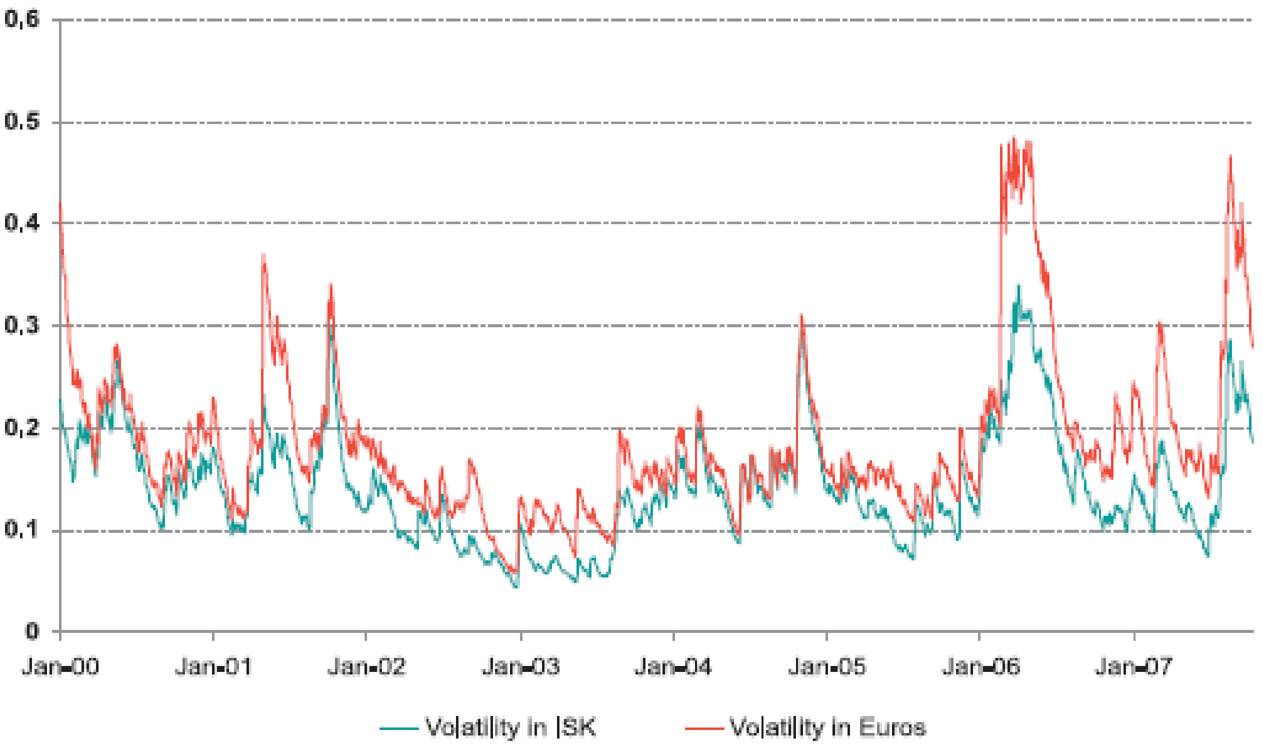
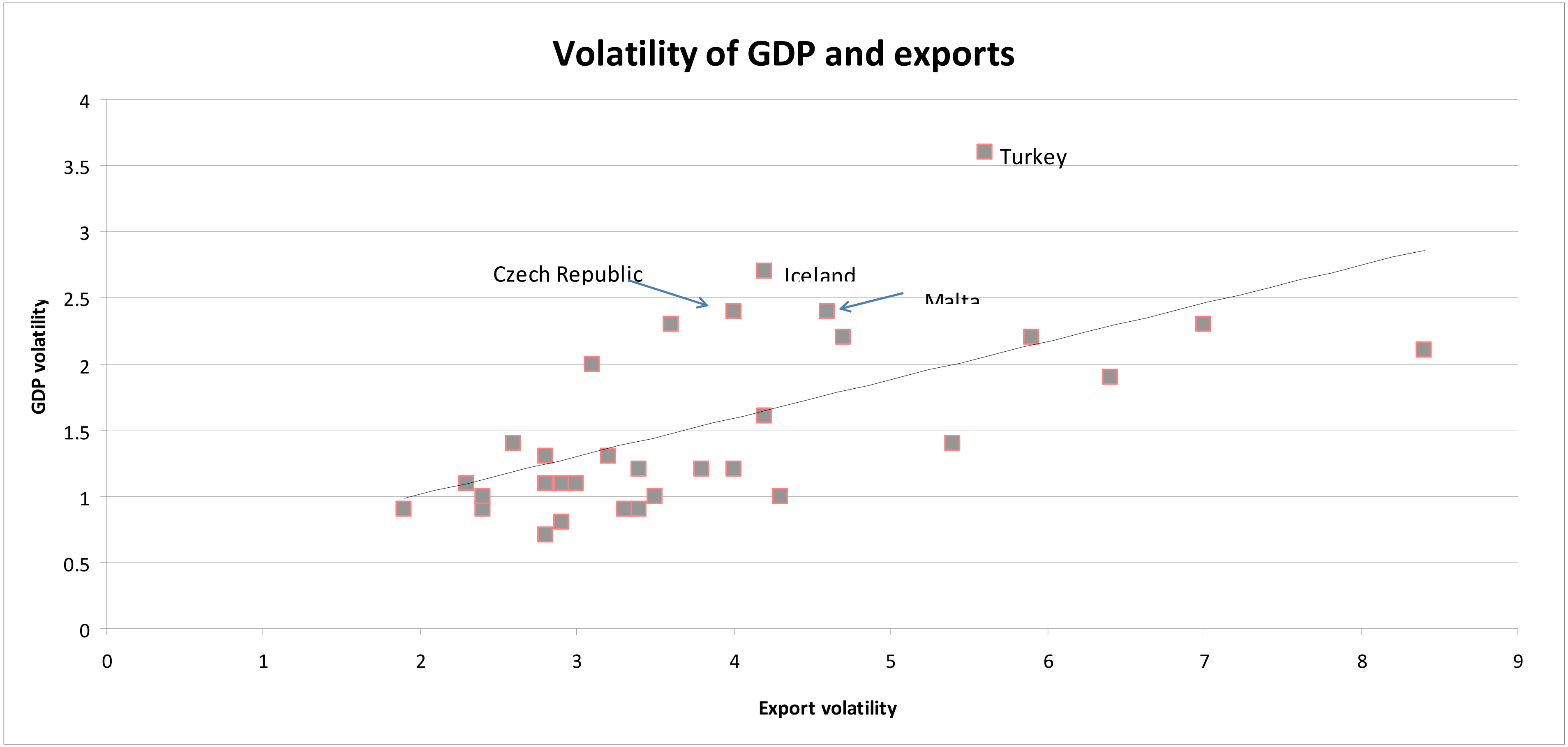


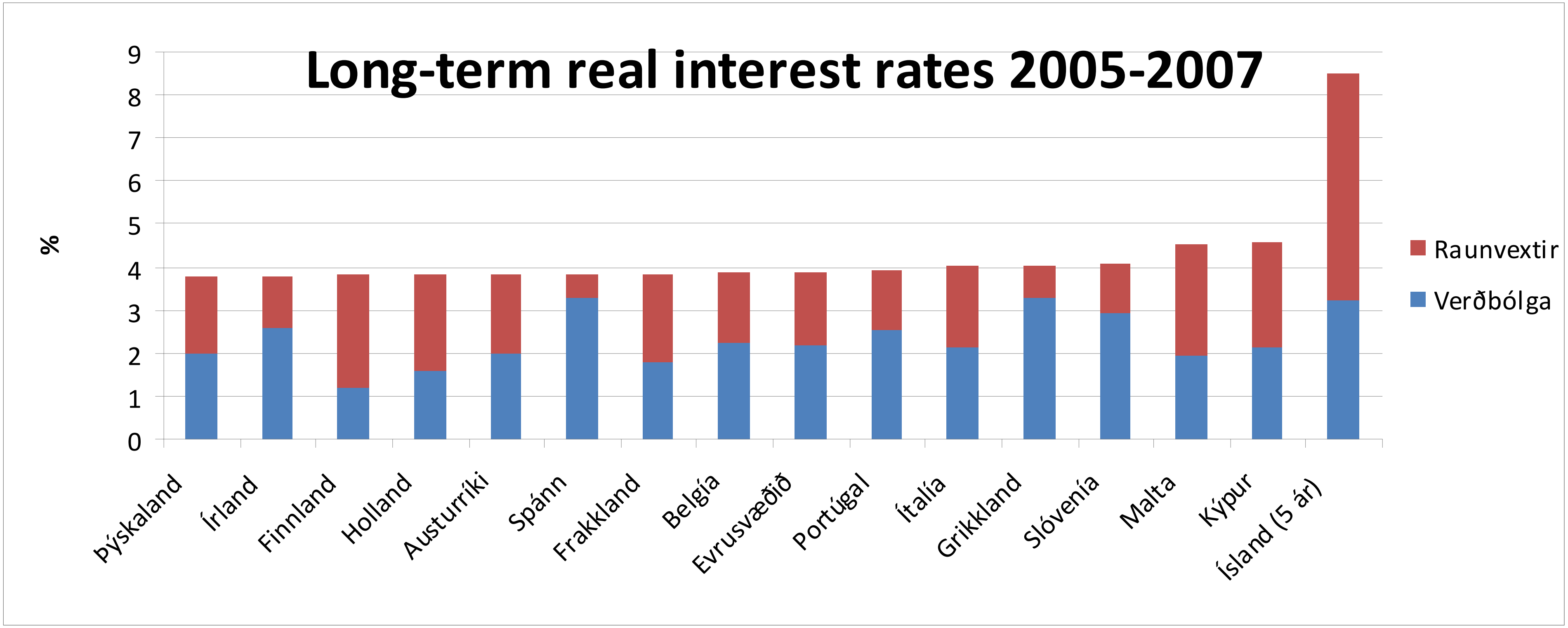
FIGURE 26
OMXI15 INDEX VOLATILITY IN ISK VS. EUR

Source: OMX Iceland and authors' calculations

The shocks aren't coming from trade: GDP highly volatile relative to exports



Very high real interest rates



Iceland’s gradual, partial financial euroisation is highly problematic

- *Unlikely to stop spontaneously*, even if monetary policy credibility improves
- Unstable demand for money hinders monetary policy
- Cross-country studies show financial dollarisation →
  - prices very sensitive to monetary shocks
  - growth slower and more volatile
  - financial fragility due to currency mismatches, so pressure on CB to keep exchange rate stable
  - thus monetary policy constrained
- Might lead to currency substitution
- Not a pretty picture

A few benefits, but...

- Some lower transaction costs for firms
- Firms and households borrow at lower (foreign) interest rates, but take on exchange-rate risk – except insofar as CBI guarantees no major depreciation (analogous to carry trade)
- Partial euroisation is untidy, perhaps unstable
- Even messier: international companies (and their employees) shift to euro, while the rest of the economy stays on ISK
- You don’t want to go there...

So what about unilateral full euroisation?

- Needn't limit political independence – 33 independent countries have remained *continuously* in currency unions since 1945 (Luxembourg, Panama,...)
- No clear relation to size: some large countries, some small do not have their own currencies
- Perfectly feasible – foreign exchange reserves comfortably exceed base money
- So look at costs and benefits

Costs of adopting the euro

- Giving up domestic currency implies giving up monetary policy and giving up exchange rate as an adjustment mechanism
- This matters: if economy were hit by an *asymmetric shock* and prices are sticky, nominal exchange rate changes could quickly change the real exchange rate (competitiveness), and that would help adjustment

But would Iceland be giving up that much?

- Nominal exchange rate movements can't offset real shocks (*e.g.,* oil price changes) – they help only in the transition
- Prices aren't sticky: with high exchange-rate passthrough, *real exchange rate changes will be short-lived*, so keeping nominal exchange rate as adjustment mechanism doesn't help much
- And how independent and effective is monetary policy *now*? – with high passthrough and big carry trade – despite 'best-practice' inflation targeting run by very able central bankers at CBI

Other costs

- Loss of seigniorage (0.2 % of GDP)
- Loss of lender of last resort (LLR)
  - but that's only useful if the problem is illiquidity – if it's insolvency, public funds (taxes) are needed for a bailout anyway
  - and even now, the big banks are not only too big to fail, they are also probably too big to rescue, in the sense that their short-term foreign currency liabilities exceed CBI resources

Alternative adjustment mechanisms

- High labour mobility – as for Iceland now
- Flexible wages and prices (otherwise adjustment can be painful, as in Germany, or postponed, as in Italy)
- Fiscal tax and transfer mechanisms across countries using euro – won't happen
- Larger capital market – what formerly were current account deficits and surpluses are now financed 'automatically'

Economic benefits of euroisation (too many for one slide…)

- *Favors trade and investment* – 'one money, one market' – hence faster growth: recent estimates suggest adopting euro could raise trade with EMU members by 60%, with GDP going up by 4%
- *Transactions costs down* – cash management costs, currency risk, forex commissions
- *'Price transparency'* – market segmentation eroded
- A larger, wider, deeper, more liquid *capital market* → corporate restructuring, investment, and growth

…more benefits

- *Anchoring expectations* gives macroeconomic stability
- *Speculative attack impossible* – no currency risk, no associated risk premium in interest rates
- *No carry trade*
- *No currency mismatch*

How does unilateral euroisation differ from EMU?

- No seigniorage – but that's not huge
- No LLR – but LLR arrangements in EMU are not clear, never tested
- No representation around the monetary policy table – but Iceland in the EEA has accepted and implemented all EU 'Single Market' regulations without having any voice in them – *why not monetary policy without representation*?

Bottom line...

- ...seems clear to me!
- Hard to see how much you can do to de-euroise except push big banks and some other major companies out of town
- But explicit unilateral euroisation is a political decision, though perhaps without political implications
- If you do it, the transition won’t be easy
- Still, you needn’t wait until all domestic imbalances are fixed first (the ‘doctrine of unripe time’) – look at how interest rates adjusted in ‘convergence path’ for EMU new entrants, as expectations changed
- So go for it? (and think more about EU entry...)