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Parliamentary resolution

on reforming the mechanism of monetary creation.

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Althingi resolves to appoint a committee of members of parliament (MPs) to carry out a review of the arrangements of money creation in Iceland and to make recommendations for improvements. The committee will be composed of six MPs, one from each party. The parliament provides the committee with facilities, one employee and necessary professional assistance. Government agencies shall advise the committee. The committee is to deliver its findings in a report to parliament no later than ten months after its founding.

Report

For more than half a century, Iceland has struggled with serious monetary problems, such as inflation, currency depreciation, asset bubbles and a full scale collapse of the banking system. The currency has lost 99.7% of its purchasing power since the Central Bank of Iceland (CBI) was established in 1961. The Icelandic krona is actually not unique in this respect, as other world currencies are all based on the fractional reserve system. For example, the British pound has lost 99% of its purchasing power and the American dollar 96% in the past century.

Despite various improvements to the legal framework of financial institutions, the problem related to the ability of banks to create money in the form of deposits, has not been addressed. This system has been increasingly criticised by experts as it provides banks with both the incentive and the opportunity for more money creation, far beyond the needs of the economy. It is therefore timely for elected representatives to perform an independent review of the mechanism of money creation in Iceland and make recommendations for improvement of the applicable legislation.

A recent report by Frosti Sigurjósson on possible reform of the monetary system, *Monetary Reform - A better monetary system for Iceland*, discusses the current mechanism of monetary creation in Iceland and addresses the fundamental problems inherent to this system. In the summary of the Icelandic report it states:

> "It is evident that the fractional reserve system provides both an incentive and the ability for the financial institutions to expand the money supply in Iceland. CBI seems unable to restrain the expansion. This arrangement seems to have contributed to the expansion of the money supply in Iceland by nineteen fold in the fourteen year period leading to the collapse of the financial system in 2008.

Apparently the fractional reserve system has also contributed to problems such as hyperinflation in the eighties, high capital costs and increased debt in society.

The fractional reserve system enables depository institutions to create sight deposits which can be used instead of cash to pay taxes and debts. The CBI creates cash (notes and coins) which, however, constitute only a small fraction of the total money supply. The money supply, which the economy could not do without, depends on banks always being solvent.

The shortcomings of the fractional reserve system have been known for a long time and various implementations of reforms have been proposed. The aforementioned report discusses some variations of reforms and one in detail. One might call it "Sovereign Money", as its reforms ensure that only the central bank can create any form of money used for payments. The pros and cons of Sovereign Money are detailed in the report, along with steps necessary to implement such a system.

The decision on implementation has to be based on informed dialogue among the public, experts and politicians. At the same time it would be desirable to initiate a thorough analysis of whether Sovereign Money is a viable option for Iceland and concurrently seek measures to reduce the risks inherent inthe current system.

10.3.1 Why is improvement of the monetary system needed?

The fractional reserve system has been subject to increased criticism. Former Governor of the Bank of England [Lord Mervyn King, 2010] has called it the worst of all possible monetary systems and has called for urgent reforms. Adair Turner, the former chairman of the UK's Financial Services Authority agrees, although he has not stated it as strongly. The following is a summary of the main drawbacks of the fractional reserve system and examines how they might have appeared in Iceland.

10.3.2 CBI has little control over monetary creation

Commercial banks create new money in the form of deposits when they issue new loans and when the loans are repaid, the money disappears. The CBI creates only a small fraction of the money supply in Iceland. If commercial banks require base money caused by too high lending growth, CBI has no choice but to provide it. Otherwise, CBI loses control over the level of interest rates or creates a risk of liquidity squeeze for banks.

CBI had to provide the banks base money as they increased the money supply nineteen-fold in Iceland during the period of 1994-2008. CBI raised policy rates and warned against inflation, but with little effect. Banks accelerated the expansion of the credit bubble until it exploded.

In order to contain the credit bubble, CBI should have had put more rigid constraints on credit growth of the banks and especially limit their lending to investment companies and speculators.

10.3.3 Commercial bank lending amplifies economic cycles

During fast economic growth, banks strive to issue loans and the demand for loans remain high. This credit growth increases the money supply which further expands the economy. Increased money supply can inflate property prices which encourages the banks to further expand lending. During low economic seasons banks are less motivated to issue loans and borrowers struggle to repay their loans. As a result, the money supply stops expanding and may even contract. This withdrawal of money and spending from the economy exacerbates the recession, hence deepening the downturn in the economy.

The credit conduct of the banks therefore amplifies economic cycles, as a result of each bank persuing its own commercial self-interest. In the pre-crisis years the banks worked to increase their lending and borrowers were optimistic and borrowed high amounts. Money supply multiplied and the growth of the property bubble. Since the economic crash, the rate of money creation has been very limited as most borrowers have been attemping to repay their debts.

10.3.4 Money growth has been too rapid

For decades the Icelandic commercial banks increased the money supply many times faster than the economy could bear. In the period of 1986-2006, economic growth was 3.2% per year. Over the same period, the banks increased the money supply by a yearly average of 18.6%.

The growth in money supply was therefore six times faster than economic growth and was an important cause of inflation and devaluation of the krona over the period. The central bank raised interest rates repeatedly from 5.6% in 2004 to 18.0% in 2008. This tripling of policy rates did not suffice in order to contain credit growth, but it led however to an inflow of foreign capital and strengthening of the króna. Banks started to offer foreign currency-denominated loans in bulk. In 2008 the consequences of high money supply and the credit bubble couldn't be avoided as the banks collapsed along with the króna. The exchange rate of the USD went from 63 ISK to 120 ISK.

10.3.5 The government misses out on seigniorage

It is reasonable to estimate that if the Icelandic Central Bank creates the money needed in order to meet economic growth and inflation targets, its profit from the activity would be around 20 billion ISK a year. Instead, depository institutions have handled the money creation and received the benefits of doing so.

The excess profit of depository institutions come from their ability to fund the lending activity through issuance of deposits which have the properties of money and enjoy indirect state guarantee. This guarantee does not entail any fee for the institutions. As deposits are an easy and safe medium of exchange, depositors are willing to accept low interest on them. As a result, the funding cost of the banks is substantially lower than it would otherwise be which is their benefit from creating money.

10.3.6 Deposit state guarantee are inevitable

Though a deposit is a convenient medium of exchange, it does not come without risk. Deposits are a liability of the bank which issued them and are a promise to pay the depositor cash (notes and coins) without notice.

In the fractional reserve system banks only have enough cash to repay a small fraction of the deposits. Usually this is not a problem as depositors find it more convenient to hold deposits than cash.

However, if fear of potential insolvency of a bank spreads, there can develop a race between depositors to withdraw their deposits before the bank runs out of cash. Such a run forces the bank to sell its assets quickly in order to free up capital. Due to the rush, it is likely that the bank will sell its assets at a discount which can lead to a drop in asset prices. This can cause more banks to run into trouble and their depositors to start running on those banks. The consequences can become a chain reaction and a complete banking crisis.

A government which faces a bank run will be forced to guarantee deposits in the hope to calm depositors.

In the year of 2008 worried depositors started to increase their withdrawal of deposits. The run did not stop until the government of Iceland had announced a guarantee of deposits.

10.3.7 Intended government guarantees on deposits increases the risk appetite of banks.

Since depositors can rely on the state guaranteeing deposits, they have no motivation to choose a bank that focuses on security rather than one that pays the highest rate of interest. Banks will therefore aim to maximize returns and in order to do so, take greater risks.

In 2006, Landsbankinn began to offer deposit rates that at the time were among the highest in the UK. When the bank collapsed, 300,000 customers had deposited 4 billion pounds in the Landsbanki Icesave accounts.

10.3.8 Intended government guarantees on deposits distorts competition in the financial market

Only deposit institutions can finance themselves with government-guaranteed deposits. Investment banks and other financial institutions do not enjoy the same advantage. They therefore need to finance all loans with equity or by borrowing on the market.

10.3.9 Deposit guarantee scheme fails its purpose in small markets.

Iceland has three large banks with more than 90% of the deposits. If one bank experiences liquidity problems, the deposit guarantee scheme will not suffice to avert a run and a possible chain reaction. The government will therefore be forced to declare a state guarantee to prevent a run.

Deposit insurance causes a cost increase of banking operations, but does not create actual insurance coverage. The system reduces the consumers‘ restraint, which increases the risk appetite of banks and the likelihood of failure.”