A speech
by
the President of Iceland
Ólafur Ragnar Grímsson
at a conference in honour of
Professor Edmund Phelps
University of Iceland
31 August 2007

Ladies and Gentlemen,

When Professor Edmund Phelps received the Nobel Prize in economics last year, it was in some sense a confirmation of what had for a long time been widely accepted among academics and policy makers, that Professor Phelps is one of the giants of modern macroeconomics. There were also many in Iceland who celebrated this achievement due to the strong ties Professor Phelps has had with our country. We took pleasure and pride from his placement on the pedestal of Nobel Laureates. It was almost as if an Icelander had received the great prize.

This relationship with Iceland is rooted in the period when Professor Gylfi Zoega became his student and, later, co-worker; but the big debut was, however, in 1999 when Professor Phelps made the keynote speech at a conference organised by Gylfi, and by Tryggvi Thor Herbertsson, who was then the Director of the Institute of Economic Studies at the University of Iceland, and Már Gudmundsson, who was then the Chief Economist of the Central Bank of Iceland.

As well as Professor Phelps the conference featured several internationally renowned economists and resulted in a book titled "Macroeconomic Policies: Iceland in the Era of Global Integration." It was then that I had the fortune to meet Professor Phelps at Bessastaðir for the first time and enjoy his contribution to stimulating discussions.

Professor Phelps has visited our country regularly in recent years, given presentations at conferences or visited the University of Iceland, and in 2004 he was made *Doctor Honorius Causa* from the University.

There are others certainly better qualified to provide you with an extensive account of Professor Phelps' contributions to economics but I would like to make a few remarks here today with respect to Icelandic experience.

Professor Phelps was awarded the Nobel Prize in economics for his analysis of intertemporal trade-offs in macroeconomic policy. The core of which was, we could say, summarised in the old Edda poem more than a thousand years ago:

> Hjarðir það vitu
> nær þær heim skulu
> og ganga þá af grasi.
> En ósvinnur maður
> kann æva-gi
> síns um mál maga.

Or in English

> The herd knows its homing time,
> And leaves the grazing ground:
> But the glutton never knows how much
> His belly is able to hold,

The Icelanders have learned the hard way about intertemporal trade-offs, both in the case of macroeconomic policies and in other areas. Possibly, we paid less attention to these in earlier periods than we do now due to the shifting fortunes of nature and what seemed at the time to be limitless fish stocks. Under those circumstances it was not always clear that today's harvest and consumption might be at the expense of future generations.

Now, however, the limits of Iceland's natural resources, including fish stocks, are much clearer and we have grown accustomed to thinking in terms of intertemporal optimisation when discussing how big fish catches should be each year. Using the terminology of economics, Icelanders currently strive to harness their fish stocks to maximise sustainable consumption, just as the king of Solovia, – in one of Phelps' most illustrious papers – tried to calculate how much his nation should save to maximise consumption.

Professor Phelps' best known contribution is probably his formalisation of the insight that actual inflation depends not only on the current degree of slack or excess demand in the economy, but also on inflation expectations. Assuming that those expectations will eventually catch up with actual inflation, we get the fundamental result that there is no long run trade-off between unemployment and inflation.

This has since become a fundamental tenet of modern macroeconomics and a key element in monetary policy around the world. However, the dynamic path towards this long-run position, as well as the short-run costs in terms of output and employment entailed by reducing inflation, depend on how inflation expectations are formed. In his original contribution Professor Phelps assumed adaptive and backward-looking expectations, whereas later on forward-looking and, even more restrictively, rational expectations became popular in the economic literature. Iceland's experience shows that both backward-looking and forward-looking expectations can be relevant and that their relative weights change from one time to another

The story of inflation and disinflation in Iceland is broadly consistent with Professor Phelps’ theories. Macroeconomic policies during much of the 1970s and 1980s had allowed a situation where excess demand was the norm and the unemployment rate was for long periods around or under 1%, which was probably below Phelps’ natural or equilibrium rate. One of the key elements that contributed to this situation was a strong devaluation bias. The result was that inflation had a strong tendency to ratchet upwards, being reinforced by negative external shocks and widespread indexation of wages.

When this cycle was broken in the late 1980s and early 1990s, there were three key elements to that transformation. First, macroeconomic policies allowed more slack in the economy than had been the case during much of the 1970s and 1980s. Second, the exchange rate was pegged at a realistic level in December 1989. Third, an almost nationwide wage settlement was achieved in February 1990, based on forward-looking inflation expectations. At the time the 12-month inflation rate was running above 20%. However, the unions agreed to base their claims on an average annual rate of nearly 7% for 1½ years, on the premise that the forward-looking annual inflation rate would be even lower. But that was not a foregone conclusion so it took extensive persuasion, strong leadership and wide-spread confidence-building to bring it about.

As you know Professor Phelps is credited with saying that he brought people into macroeconomic models and I can assure you that there were lot of people who created this Icelandic economic process and particular individuals played a crucial role. Leaders of trade unions and employers’ federations together with government ministers held intensive meetings on the formulation of these policies, often in secret, sometimes one-on-one; formal processes and protocols were put aside. And it worked. At the end of the contract period inflation was down to around 7% and real wages had increased between 1990 and 1991.

For a more extensive analysis of this process and of inflation and disinflation in Iceland I refer you to a paper written by the late Palle Andersen at the Bank for International Settlement and my friend Már Gudmundsson who was during this crucial period my economic advisor in the Minestry of Finance.

The paper was published in January 1998, by both the Bank for International Settlement and the Central Bank of Iceland.

I must, however, make three qualifying remarks.

First, this was a case of centralised wage bargaining, whereas Professor Phelps worked with more decentralised labour markets.

Second, the settlement was strictly speaking not based on the inflation expectations of the public but rather on inflation forecasts made in the Ministry of Finance and the Central Bank of Iceland. For the contract to be accepted, the leadership of the trade unions and the majority of active trade union members had to be convinced that the effort had at least some credibility.

Third, it cannot be claimed that inflation would not have been tamed in Iceland without this historic settlement, but it would have been much more difficult and much more costly in terms of short-term losses of output and employment.

I have used this opportunity to emphasize how Professor Phelps' theory of the inflation process finds resonance in Iceland's economic history. The reason is partly that as a Minister of Finance at the time I was deeply involved with economic policy in the late 1980s and the beginning of the 1990s and is therefore impressed by how Professor Phelps' work throws light on our national experience.

In the best tradition of other great economists who came before him Professor Phelps has shown that it is policy relevance that drives the research agenda, demonstrating how public policies can contribute to stable economic growth and low inflation. As that has also been the Holy Grail of Icelandic economic policy, Professor Phelps' theories are highly relevant for understanding the Icelandic journey.

It is therefore a great pleasure for me to open this conference convened in his honour and thank Professor Phelps for our stimulating discussions and his friendship towards Iceland.