Ingimundur Friðriksson: Monetary policy and its implementation

Speech by Mr Ingimundur Friðriksson, a Governor of the Central Bank of Iceland, at a Roundtable meeting held at the Central Bank of Iceland, Reykjavik, 20 February 2007.

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The interest rate decision on February 8, 2007

On Thursday, February 8 this year the Central Bank of Iceland announced that the Board of Governors had decided to leave the policy interest rate unchanged at 14.25%. A press release announcing the decision stated that inflation had slowed down and the short-term inflation outlook had improved beyond what was expected in the Central Bank's most recent forecast.[1] However, inflation was still significantly in excess of target. The current interest rate might suffice to bring inflation to target within an acceptable period of time, but significant macroeconomic imbalances were still present that posed a risk of rising inflation. If the inflation outlook took a turn for the worse, the Central Bank would respond.

Monetary policy and macroeconomic developments

In the joint declaration by the Government of Iceland and the Central Bank of Iceland on March 27, 2001, the Bank was assigned the main objective of promoting price stability. This was defined as a rate of inflation, measured as the twelve-month increase in the CPI, of as close to 2½% as possible. Broadly speaking, central banks have only a single instrument, i.e. their policy interest rate, and can therefore only attain one macroeconomic goal in the long run. Internationally, a wide consensus has been achieved between governments and economists that price stability is the most appropriate main objective of monetary policy.

The Icelandic economy has witnessed turbulent times since 2001 and undergone major structural changes, particularly in the financial sector. Iceland moved on to an inflation target under conditions of strong macroeconomic imbalances, one result of which was a depreciation of the króna by one-third over a period of eighteen months until near the end of 2001. This development led to a shortlived inflationary episode which peaked in January 2002. Afterwards inflation slowed down sharply and moved below the 2½% target before the end of 2002. It remained below or close to the target into the second half of 2004, but has been above target since then. In the current episode, the twelve-month inflation rate peaked in August 2006 at 8.4%. Since then it has been decelerating and the twelve-month increase in the CPI measured 7.4% in February 2007. However, the rise in the core indices remained above 8%. Cuts in indirect taxation will bring down headline inflation very rapidly over the next few months, although the reduction in underlying inflation will be slower.

The Central Bank has explained in detail the reasons for the inflation target overshoot over the past two to three years. Suffice it to mention here that the episode of overheating that now appears to be coming to an end originated in large-scale investments [in the power and aluminium sectors] in east Iceland and elsewhere. This was compounded by unforeseen changes in the credit market when banks began offering mortgage loans in competition with the state-owned Housing Financing Fund [HFF], after the latter announced a substantial increase in its loan-to-value ratio and mortgage amounts.

Another unexpected event was the issue of króna denominated Eurobonds [glacier bonds], one side-effect of which was to delay the transmission of the Central Bank's policy rate hikes across the domestic yield curve. The background to these transactions is a global glut of savings which has led to exceptionally low international interest rates, coinciding with unusually high interest rates in Iceland. One consequence was to divert much of the monetary policy impact into the exchange rate channel.

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[1] The press release is posted on the Central Bank's website, www.sedlabank.is

Another more positive consequence was a surge in turnover in the domestic financial markets, which deepened them by bolstering price formation and enabled them to handle much larger trading volume smoothly, without significant price volatility.

Policy rate changes are only passed through in full to domestic demand with a sizeable lag. In a small, open economy like Iceland, the impact is initially reflected in the exchange rate. Other things being equal, a rise in the policy rate causes a temporary appreciation of the króna, which squeezes the export and traded goods sectors and also channels demand out of the economy. The banks' surprise entrance into the domestic mortgage market made it difficult for the Central Bank to respond effectively. This spurred a surge in household borrowing and private consumption funded by credit. For an extended period the Central Bank's policy rate hikes primarily impacted the exchange rate and had a more subdued effect on other domestic interest rates, partly because of the glacier bond issues. Fierce competition in the mortgage market between the banks and HFF also undoubtedly delayed the force of the impact that the policy rate increases should have had on mortgage lending rates, including those of the HFF.

It should be added that changes in economic aggregates are more difficult to measure in the national accounts during rapid growth episodes, as shown by sizeable revisions to leading preliminary estimates. When the Central Bank raised its policy rate in 2004 and 2005 to counter mounting inflationary pressures, it did so on the basis of available data on macroeconomic conditions that later turned out to give a misleading picture of real developments. Revised statistics published last year showed that the economy expanded by much more in 2004 and 2005 than could be read from data at hand when the Central Bank hiked its policy rate during those two years. When the real outcome was known, it was obvious that the Central Bank should have raised its policy rate by more and faster than it did at the time. Monetary policy faces the challenge that the best available data are always imperfect, but especially so during periods of rapid change.

As I mentioned earlier, the Central Bank left its policy rate unchanged on the last interest rate decision date, February 8. In December it raised the rate to 14.25%. This was the eighteenth hike since May 2004; prior to that, the policy rate had been held at 5.3% for more than a year. The Central Bank noted that its December hike seemed to come as a surprise. The introduction to *Monetary Bulletin*, which was published on November 2, stated that a reduction in the policy interest rate was still not in sight, in spite of substantially brighter inflation prospects. On the contrary, it was impossible to rule out a further policy rate hike in order to attain the inflation target within an acceptable timeframe, and the analysis presented then implied that there were still grounds for tightening the monetary stance further. However, the Board of Governors had decided to postpone such a measure for the time being. The next interest rate decision, to be announced on December 21, 2006, would be based on the analysis in the November *Monetary Bulletin* and additional data that became available by that time. The Chairman of the Board of Governors underlined this message from *Monetary Bulletin* in a speech a few days later when he described the decision to leave the policy rate unchanged on November 2 as a deferral of an increase rather than the end of the tightening of the stance.

When it was decided to raise the policy rate on December 21, it was known that inflation had slowed down to considerably below the midyear forecast rate. Inflation was mainly brought down by lower energy prices, the impact of the appreciation of the króna since the middle of the year, less-than-expected wage drift and a slowdown in house price inflation. Domestic demand in Q3 was broadly in line with the Central Bank's November forecast. It was also known that the current account deficit was wider than expected in Q3 and would significantly overshoot the forecast for the year as a whole. No indications of easing labour market pressures could be seen. Unemployment was negligible and there was a large influx of foreign labour. Despite lower inflation than in the Bank's July forecast, there was still no sign that the target would be attained within two years if the effect of indirect tax cuts on headline CPI in the first half of 2007 was ignored. Furthermore, the wide current account deficit and tight labour market aroused suspicions that pressures in the economy were underestimated, and thereby inflationary pressures as well.

As mentioned earlier, policy rate hikes primarily impact the exchange rate. The króna appreciated substantially until near the end of 2005. By then it was considerably stronger than was compatible with external balance in the economy, as the Central Bank had explained in detail, among other things in its December *Monetary Bulletin* that year. So it was not surprising that the króna depreciated. What was unexpected was how soon and how fast the króna fell. It depreciated by 19% against the exchange rate index over 2006 as a whole and all the weakening was confined to the first half of the year. So far in 2007 the króna has been roughly 15% weaker on average than at the beginning of 2006. By comparison, the US dollar depreciated against the euro by almost 11%. For most of the period since the middle of 2006, the króna has fluctuated within a fairly modest range. Since the end of the sharp depreciation in the first half of last year the króna can be described as relatively stable and marginally above its long-term average value. At present, the real effective exchange rate is slightly stronger than on average over the last quarter of a century.

A wide current account deficit could potentially erode confidence in the króna. The Central Bank has underlined the importance of restoring macroeconomic balance by realigning domestic demand with output capacity, and of establishing a sustainable external balance by such means rather than through a sharp currency depreciation that would fuel inflation and other instabilities. Inflation developments depend heavily on the króna not slipping much from its level over the past few months, at least for as long as pronounced macroeconomic imbalances remain. Confidence in the exchange rate will be a crucial factor over the coming months. It should also be pointed out that exchange rate movements can be the result of external events or changes beyond our control, such as a sudden shift in international investors' risk perceptions or global credit supply. The exchange rate of the króna is closely linked to developments in capital markets elsewhere in the world, especially while the current account deficit is as large as at present.

Inflation and macroeconomic forecasting

The Central Bank bases its monetary policy formulation and implementation on the inflation and macroeconomic forecast that it prepares three times a year and publishes in *Monetary Bulletin*. Forecasts are always uncertain and by definition can never state precisely what will happen over the forecast horizon. The Central Bank forecasts are based on extensive research and analysis, and on models that have been developed to simulate how events are likely to unfold. A major advance was made in 2006 with the introduction of a new macroeconomic model designed by Central Bank economists. The Central Bank has always expressed qualifications about the accuracy of its forecasts, and readers of *Monetary Bulletin* will be familiar with the risk profiles that draw attention to forecasting uncertainties. Another uncertainty is the output gap at any time, which is an important determinant of the inflation outlook. However, the economic laws are known and are the same as everywhere. Forecasts are prepared on the basis of the best available information and known correlations between changes in aggregates. They therefore provide a sufficiently good indication about future developments to enable the Board of Governors to make decisions on the basis of them. Better forecasts have not been available.

Nonetheless, the Central Bank has frequently been criticised for the quality of its forecasting and the allegedly incorrect monetary policy decisions based on them. For example, the Bank came under harsh fire for raising the policy rate in the second half of 2006. It was claimed that the forecasts were wrong and the hikes therefore unnecessary. In some cases, critics selected limited and minor areas of Central Bank forecasts which they considered to be based on incorrect assumptions, and dismissed the entire forecast as a result.

Now that the year is over, it is obvious, of course, that the Bank's forecasts did not fully hold. For instance, in July 2006 the Bank forecast higher second-half inflation than proved to be the case. Explanations for the deviation include the appreciation of the króna after the middle of the year, the effect of lower global fuel prices on the price level, and the fact that wage settlements made in the middle of the year did not provoke wage drift on the scale that the Bank had forecast in July. The first two factors were hardly foreseeable, and it should be pointed out that the Bank's overforecast for wage drift was not far from that made by the social partners themselves when the wage settlements were signed. Be that as it may, the economy was no less overheated than forecast in mid-2006, as witnessed by the current account deficit and tight labour market. Thus it is untenable to claim that the Central Bank's policy rate hikes in 2006 were unwarranted. On the contrary, a higher policy rate was the main precondition for the króna to hold relatively strong, and contributed to subduing demand growth. Had the Central Bank not raised its policy rate, there is little doubt that inflation would be higher than at present.

Some commentators who were surprised by the December policy rate hike apparently considered that the Central Bank had underestimated the scope of the turnaround in the economy in the second half of the year. National accounts statistics for Q3 that were published in mid- December, supposedly showing a substantial slowdown in economic activity, were repeatedly cited as evidence. The Central Bank considers it imprudent to draw sweeping conclusions solely from preliminary estimates in the quarterly national accounts, which tend to undergo sharp revisions. For this and other reasons, a broader range of indicators contributed to the December policy rate decision, including the current account deficit and labour market conditions.

The scenario today is that commercial bank analysts expect the cycle of policy rate cuts to begin later this year than they were forecasting towards the end of 2006. In other words, they consider that more underlying pressures remain in the economy than they may have thought at the time.

Interest rate assumptions in Central Bank forecasts

Various changes have been made to the exchange rate and interest rate assumptions behind the Central Bank's forecasts in recent years. In the early years of inflation targeting, forecasts were based on the assumption of an unchanged exchange rate and unchanged policy rate over the forecast horizon. By showing how developments would unfold if the Bank left the policy rate unchanged, they indicated whether it needed to be changed. In December 2004, the first alternative scenarios to the baseline forecast were presented which assumed changes in the exchange rate and interest rate over the forecast horizon. In December 2005 the same baseline forecast was used, but in the alternative scenarios, the policy rate path followed financial market analysts' forecasts and the exchange rate was extrapolated from uncovered interest rate parities. These approaches were developed further in 2006 and the baseline forecast in July and November was based on a policy rate path calculated from forward interest rates and analysts' expectations. The alternative scenarios assumed, respectively, an unchanged policy rate and a policy rate path that would bring inflation to target within the forecast horizon.

Earlier forecasts based on an unchanged policy rate across the horizon, in an environment where there was an obvious need for a sharp hike, produced a misleading picture. They presented developments that the Bank had to explain would never materialise. The baseline forecast in *Monetary Bulletin* in November 2006 represented an enhancement insofar as it was based on market expectations about policy rate changes. The Central Bank incorporated these expectations into its baseline forecast, even though it considered them unrealistic. They assumed rapid cuts in the policy rate commencing early this year. The Central Bank considered neither assumption to be compatible with the inflation outlook. Thus the forecast lacked credibility, in the Bank's own opinion.

This prompts the question of what assumptions it is natural for the Central Bank to make about the policy rate in its baseline macroeconomic and inflation forecasts.

Iceland is not the only country whose central bank has faced such a challenge. Several years ago, the Reserve Bank of New Zealand responded by using its own policy rate forecast as an assumption. The Bank of Norway followed suit two years ago and now uses a future interest rate path forecast by its Executive Board for its baseline forecast. Sweden's Riksbank recently announced that it will use its own forecast for the repo rate path as an assumption in its inflation forecast. These banks have followed a similar course to the Central Bank of Iceland in developing the interest rate assumptions behind their forecasts. They have now opted to use the path that is forecast by those who actually determine the policy rate, partly because they did not consider market agents' forecasts and expectations sufficiently credible. At the same time, these central banks have firmly stated that their policy rate forecasts entail no commitment to hold their rates to that path. The policy rate must always be decided on the basis of the best available information at any given time. Experience shows that paths change sharply from one forecast to the next and the central banks explain the assumptions behind such changes thoroughly. Above all, these central banks aim to exert a specific effect on expectations, which is the principle behind a successful monetary policy. This appears to have produced results in New Zealand and Norway.

Another option is for the baseline forecast to assume a policy rate path calculated from a monetary policy rule that steers inflation to target within the forecast horizon. This was done in the alternative scenario published in the November 2006 *Monetary Bulletin*.

Other inflation-targeting central banks take different approaches, including the assumption of an unchanged policy rate as the Central Bank of Iceland initially did after moving onto an inflation target. The choice of assumptions for the Central Bank's next macroeconomic and inflation forecast has yet to be decided. It is still under consideration and discussion in-house. What is crucial for the Central Bank is the credibility of its forecasting and the ability to exert the impact on expectations that it deems necessary.

Conclusion

It is not the Central Bank of Iceland's policy to maintain high interest rates. However, this is necessary for as long as the recent macroeconomic conditions prevail. High interest rates subdue private consumption and investment. The impact of interest rate changes is transmitted with a lag, but monetary policy gradually delivers results, now as ever. Reducing imbalances and restoring stability is in everyone's interest. Some strain is inevitable during an adjustment from heavy imbalances, so complaints come as no surprise. But this does not mean that the wrong monetary policy measures are being applied – it could even mean quite the opposite.

The Central Bank's policy rate is high. The press release announcing the Board of Governors' decision on February 8, which I quoted earlier, stated that the current interest rate may suffice to bring inflation to target within an acceptable period of time. It is impossible to state this categorically now, because it depends on the inflation outlook. What is certain is that the policy rate will be lowered as soon as the Central Bank deems this compatible with the inflation target. It is wrong to claim that this is ruled out because the interest rate differential with abroad must be maintained to prevent turbulence when glacier bonds mature. However, an untimely reduction in the policy rate will benefit no one.

It has been claimed that the Central Bank is undermining the króna with its interest policy, which will cause businesses and households to abandon the currency. In this context it must be remembered that without a tight monetary stance and high interest rates, the króna would probably have depreciated by more than it actually did, demand would have grown faster and inflation moved much higher. This would have had serious consequences for indebted households and businesses, as well as causing turmoil in the labour market and, ultimately, even more instability in the economy.

Other central banks have periodically needed a very tight monetary stance to bring inflation under control. For example after 1980, roughly a quarter of a century ago, the US federal funds rate was significantly higher for a while than Iceland's current policy rate. This proved necessary in order to rein in inflation that was also higher then than in Iceland today. This policy was successful and the US has not faced a serious challenge from inflation since.

Ideas for an economic panacea have also been aired, typically involving the adoption of the euro. The Central Bank has already stated its view that adopting the euro would be imprudent except by joining the EU. Even though Iceland were to decide to apply for EU membership, it would not be able to enter into the Monetary Union until several years later, after fulfilling all the accompanying conditions which include criteria for inflation, interest rates and exchange rate stability. Experience shows that no concessions are made from these conditions. It is also important to remember that membership of a larger currency area does not eliminate the need for sensible economic policy. What changes is that monetary policy independence is lost. Decisions on consumer prices and unit labour costs relative to abroad would be transferred to the respective markets. This would make fiscal and wage flexibility even more vital in order to tackle cyclical fluctuations. In the current adjustment of the economy, the exchange rate of the króna has played a key role. Without a flexible exchange rate, the crucial instruments for tackling prevailing economic conditions would have been tight fiscal restraint, cuts in public spending and/or higher taxes, to help ensure that sharp rises in wages and prices did not excessively weaken the competitive position of Iceland's trading sectors.

Exchange rate volatility in the recent term was fuelled by the overheating of the economy, which is now cooling once more. The crucial factor for near-term exchange rate developments is to restore economic stability in Iceland with inflation on target, and to secure it in the longer run with prudent economic policies. It is doubtful whether claims that economic policy would necessarily become more prudent, if Iceland switched to the currency of a larger currency area, are justifiable.