Már Guðmundsson: Monetary policy objectives and developments in the Icelandic economy

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at a breakfast meeting of the Iceland Chamber of Commerce, Reykjavik, 6 November 2009.

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In general, monetary policy is conducted under conditions of uncertainty. The future is always uncertain, of course, but so are the present and the recent past – at least, when one is assessing the state of the economy. This is axiomatic to anyone who has had to wait for national accounts figures in order to estimate current GDP growth and has then seen statistics revised repeatedly over a period of several years. Another source of uncertainty is the effect of monetary policy instruments on other interest rates, exchange rates, asset prices, demand, and inflation. Naturally, we know a great deal about the relationships in the economy, but we don't know what the correct model of it is, and we probably never will, as economic structures change over time. Furthermore, expectations play a key role in the entire process, and while they may remain reasonably stable for a time, other periods of time will come, and expectations will become unhinged. The relationship between interest rates and exchange rates under conditions of free cross-border movement of capital is different to the relationship that exists under capital account restrictions. In general, the monetary policy transmission mechanism depends on the maturity of the financial markets. These uncertainties and complexities, of course, are the reason for monetary policy committees and heavily staffed central banks.

If monetary policy is complex under normal circumstances, the complexity is multiplied in a financial crisis, especially a crisis as deep as the one that Iceland has been going through. Some of the markets that are important for monetary policy transmission stopped functioning to a substantial degree. Financial institutions became impaired, and they responded differently to the Central Bank's monetary policy instruments than they did before the crisis. The relationship with the rest of the world changed. The link between exchange rates and interest rates weakened. And expectations became seriously unstuck. Matters were further complicated because we had to change the rules of the game in response to the crisis; for example, by imposing capital controls.

It is important to remember this when evaluating monetary policy in Iceland under the current circumstances. At present, the monetary policy framework is defined by the economic programme agreed between the Icelandic Government and the International Monetary Fund (IMF). The other key elements of the programme are the medium-term fiscal sustainability plan and the financial market restructuring plan.

According to the programme, the most important task of monetary policy is to promote exchange rate stability. One reason for this is the currency crisis that accompanied the financial crisis, pushing the exchange rate far below levels previously thought possible, let alone desirable. This currency collapse fuelled inflation, of course, and amplified the debt crisis faced by households and businesses. Two factors played leading roles in that development. The first is the relatively large share of foreign-denominated loans – an average of 20% for households and 70% for businesses. The latter factor is an unusually strong exchange rate pass-through effect, which stems from the magnitude of the exchange rate drop and the lack of confidence that the króna would recover in the near future. As a result, the principal of indexed loans – which constitute about 70% of household debt and 10% of business debt – was written up. As is often the case in severe financial crises that are at the same time country crises, there was a genuine risk of a multi-faceted spiral of currency collapse, inflation, debt crisis, and economic contraction. It was critical to stave off such a vicious cycle, and therefore of vital importance to stabilise the exchange rate.

But this was problematic because of the large amount of capital that had accumulated in Iceland through carry trading during the economic upswing. Current estimates indicate that some 500 b.kr. remain in the Icelandic economy. There was the risk that this money would try to escape through a collapsed foreign exchange market, with unimaginable consequences for the exchange rate. Thus it was quite possible that astronomical interest rates would have been required if exchange rate stability were to be achieved through interest rate policy alone. In view of this, it was decided to impose broad-based capital account restrictions and thereby create the scope for less restrictive monetary policy than would otherwise have been feasible.

As is usually the case, there were probably other options available at the time. But because I prefer to focus on the current situation and the road ahead, I would prefer not to spend time rehashing the past and ruminating about hypothetical options. Such speculation cannot change the past. Generally speaking, however, it seems to me that other options would have entailed significantly higher interest rates – initially, at least – and more risk to the exchange rate. But that doesn't change the fact that, although the capital controls provided a certain temporary shelter, they also entail significant cost and inconvenience, which probably vary directly with the length of time the controls are in place. That cost will ultimately cut into GDP growth for the short term and reduce the level of GDP in the longer term. Understandably, then, we do not wish to maintain the capital controls a minute longer than necessary.

Strictly speaking, monetary policy is not based on an inflation target at present – at least, not for the short term – as the interim goal of arresting the fall of the króna and then stabilising it has taken priority. Ultimately, of course, this policy is consistent with the attainment of the inflation target. It would have been tempting to take somewhat greater short-term risk with the exchange rate and direct monetary policy more toward domestic economic conditions and the inflation outlook, but the enormous damage that even a short-lived additional depreciation would have done to private sector balance sheets precluded such an approach.

Under conventional circumstances, inflation-targeting monetary policy can be described, albeit in an oversimplified way, as entailing a policy interest rate that takes into account three factors:

1) the desired policy rate when inflation is at target and GDP is at potential; 2) the output gap; and 3) the deviation of inflation from target. In the case of Iceland, the exchange rate must be added to this list, and with a heavy weight. But the weight of the other items is not zero, and the importance of the exchange rate should diminish as the financial crisis relinquishes its grip and we reduce the weight of foreign debt in private sector balance sheets, thereby reducing the impact of the exchange rate on domestic liabilities. One of the Monetary Policy Committee's many tasks at present is to assess how these various weights should evolve as circumstances change.

Indicators presented at the most recent Monetary Policy Committee meeting suggest that foreign-denominated debt may weigh less heavily in corporate sector debt than was previously believed, and that it is currently diminishing in importance for both households and businesses. Before the banks collapsed, an average of 70% of corporate sector debt was denominated in foreign currency. But the distribution is quite skewed. Holding companies had a large share, and large and medium-sized firms were more likely to have foreign debt than were small firms. Over half of businesses had domestic-currency debt only. In addition to this, the weight of households' and businesses' foreign-denominated debt will probably decline in the near future, both due to debt restructuring and because the vast majority of new bank loans are in domestic currency. The banks have limited capacity to lend in foreign currency, both because of a shortage of foreign exchange and because they are operating under temporary exemptions from Central Bank rules on maximum foreign exchange imbalances. Of course, this is good news, in a sense, because the sooner the weight of foreign debt diminishes, the sooner monetary policy will be released from the straitjacket of restraint far greater than is desirable in light of current domestic economic conditions. Other factors that could help in this context are new foreign exchange inflows and lower risk premia on domestic króna-denominated assets, which would obviate the need to maintain exorbitant interest rates in order to keep ISK assets in the country or attract new capital.

I have expanded at some length on current monetary policy objectives because I consider it important that these objectives be understood. But what are the instruments of monetary policy? It can be said that, apart from reserve requirements and other similar tools, which are seldom changed, the Bank's interest rate decisions, foreign exchange market intervention, and capital controls are its chief monetary policy instruments. These instruments must be properly aligned, and consequently, interest rate decisions take account of capital controls. The controls provided some shelter for interest rate decisions for a while; however, as soon as they are relaxed, interest rates must be high enough to give investors an incentive to hold ISK assets. Just how high they must be is determined in part by the risk premium on the Republic of Iceland, which fortunately has declined significantly in the recent term. For example, the Republic's CDS spread has fallen from around 1000 basis points at the beginning of the year to about 350 points.

But what about foreign exchange market intervention? It is a tricky instrument and, if misapplied, yields nothing at best and generates enormous losses at worst. Refusing to use it at all, however, would be unnecessarily extreme. One of the lessons of the financial crisis is that the proper deployment of foreign exchange reserves can be of key importance in preserving monetary and financial stability under difficult circumstances. This is supported by innumerable examples from countries from Brazil to Korea. There is no benefit in amassing foreign exchange reserves during an economic upswing if one is chary of using them in times of need. The public sector can take a broader view than the private sector because it is able to take a longer-term position with or against its own currency, thereby smoothing out cycles, and profit on the whole arrangement. Australia and other countries have at times used this strategy successfully, in spite of an inflation target. But there is no sense in protecting an unrealistic exchange rate through thick and thin, nor does it make sense to draw a line in the sand vis-à-vis the market. Under those circumstances, it is better to adopt the military strategy of Genghis Khan, who often began by retreating, luring his opponents from their fortresses and then annihilating them out on the steps.

At present, foreign exchange market intervention in Iceland aims at mitigating exchange rate volatility and preventing a spiral of currency depreciation and expectations of further depreciation. Since the banks collapsed, the Central Bank's foreign exchange market intervention has all been in one direction: It has sold foreign currency. In the past few months, however, intervention has been reduced significantly in comparison with, for example, January and February, and then May and June. Nonetheless, 2009 figures year-to-date are quite high, at over 80 million euros.

Is too much risk being taken? As long as intervention remains modest, I think not. There is no doubt that the equilibrium exchange rate of the króna has fallen sharply after the past years' accumulation of debt and the ensuing collapse of the banking system. I think there is little doubt that the current exchange rate is below this new, lower equilibrium rate, as is often the case in a financial crisis. However, there is great uncertainty about how far below equilibrium it is. There is also considerable uncertainty about how much the equilibrium exchange rate will rise in coming years and how much the exchange rate will correct itself. The Central Bank's newly published forecast assumes that the exchange rate of the króna against the euro will remain close to current levels until well into 2010, whereupon it will gradually rise to about 170 in 2011 and 2012. We hope, of course, that this forecast is unduly pessimistic, and experience tells us that the currency can appreciate swiftly once it gains upward momentum. But it would be imprudent to base plans and policy actions on such a hope. On the contrary: I believe we should prepare ourselves for a protracted episode of weakness. And, like so many other things, there are both pros and cons associated with such a development.

That doesn't change the fact that we would all have to make a concerted effort to botch things in order to prevent the exchange rate from being considerably higher in a few years' time than it is today. But then we will have to remember to buy back the foreign exchange that we have used to support the króna in 2008 and 2009. If we do that, then we might profit on the whole arrangement.

I expect this spurs questions about whether we need all of the loans that we have negotiated as a part of the IMF programme. In my opinion, this is an eminently justifiable question. First of all, we need the loans in order to ensure that we have sufficient foreign exchange at all times to enable us to pay amortisation and interest on the foreign debt of the Treasury and Treasury-guaranteed entities. As far as the Treasury is concerned, there will be little activity until late in 2011, when a loan of one billion euros, taken in 2006 to reinforce the foreign exchange reserves, will mature. But we can also use the loans to buy the bonds from this series and others offered in the secondary market at low prices, thereby easing the debt service burden and profiting on the whole arrangement. Furthermore, we will need reserves in order to engage in moderate foreign exchange market intervention, with the aim of supporting the króna and reducing volatility. And last – but certainly not least – we need reserves in order to create confidence in the króna and fend off those who would attack it. But such an arsenal, which is only to be used in an emergency, is extremely expensive because it is impossible to invest the reserves at rates comparable to those on the loans themselves without taking an unacceptable amount of risk. Thus it is important to avoid borrowing more than necessary and to emerge as soon as possible from our current state of imbalance.

Before I turn to the economic outlook and the Monetary Policy Committee's most recent interest rate decision, I consider it necessary to say a few words about the nature of the adjustment the Icelandic economy is currently undergoing. First of all, it should be borne in mind that the year 2009 would have been extremely difficult in any case, no matter whether the banks had collapsed or not. This is because of the huge macroeconomic imbalances that developed in the Icelandic economy in 2005-2007 and had to subside in one way or another. Second, the collapse of the banking system called unavoidably for an additional adjustment in the structure of the economy. We can summarise this as follows: The enormous current account deficit had to go, and the financial system and various other bubble-related operations had become far too large and had to be downsized. This involves considerable unemployment, partly because of layoffs in the sectors that have contracted and the lag time before new commercial activities can be established. Tradable sectors must be reinforced. The key to hastening that process is re-establishing an effective financial system. Although the currency may have played a role in creating the problem, the depreciation is also part of the adjustment, and it is accompanied by transitory inflation. However, when the adjustment is over, we should not be faced with persistent inflation, and it is the chief role of monetary policy to try to ensure that inflation does not become entrenched.

The Central Bank published a new macroeconomic forecast yesterday, as well as announcing the Monetary Policy Committee's interest rate decision. The highlights are as follows:

- GDP will contract by about 8½% in 2009 and by almost 2½% in 2010.
- The contraction for 2009 is rather smaller than previously forecast.
- Private consumption has declined less sharply so far in 2009, probably because disposable income rose more in 2008 than previously forecast, and because of pension fund payouts amounting to some 1½%of GDP in 2009.
- In addition, unemployment has risen less than previously projected.
- Recovery will begin in early 2010, in the sense that quarter-on-quarter GDP will begin to grow.

- At that point, however, Icelanders will still consider the situation unfavourable, and it will keep deteriorating for a while, as unemployment and the output slack will continue growing well into the year, as will the contraction in private consumption.
- As the second half of the year progresses, these factors, too, will begin to improve.
- As always, these projections are uncertain, and the economic recovery could prove stronger or weaker. For example, one of the alternative scenarios in the new Monetary Bulletin assumes a considerable delay in the construction of the Helguvík aluminium smelter and related power facilities, with the bulk of the development taking place in 2012. Economic recovery is delayed, and the contraction in GDP will be 4% in 2010, instead of just under 2½%.
- Inflation has been higher than forecast in the recent term, as a result of a weaker króna and a slightly smaller output slack than previously projected.
- Inflation will subside quickly in 2010, however, and underlying inflation will be at or near target in the latter half of the year.

As regards the current economic situation, the outlook I have described here, and indicators that private sector balance sheets are somewhat less exposed to exchange rate risk than previously thought, the Monetary Policy Committee decided to make changes in Central Bank interest rates that entail an unchanged or slightly more relaxed monetary policy stance. The main change, however, involves adapting the Central Bank interest corridor to the effective level of monetary restraint, which is currently determined primarily by interest on the Bank's current accounts and certificates of deposit. If the króna remains stable or appreciates, and if inflation falls as forecast, then the preconditions for further monetary easing should soon be in place.

Available forecasts assume that the Icelandic economy will recover in the next few years. We also hope we will be quick to escape the fetters of the capital controls and the predicament faced by monetary policy as a result of the debt crisis and the large proportion of foreign-denominated debt. It will then be time to determine a new monetary policy framework. Joining the European Monetary Union could be an option in due time, but it is not a certainty, and in any event, it will take some time to materialise. The most obvious choice is therefore to adopt some sort of inflation target and floating exchange rate. That is a topic for another speech, but for the moment, suffice it to say that the experience of the past several years, both in Iceland and elsewhere, indicates that such an inflation-targeting regime would have to be somewhat different than the pre-crisis regime. It must be much better supported by fiscal policy, macroprudential financial market regulation, and effective financial supervision. It would have to be an "inflation target-plus" framework, which would specifically include accumulating foreign exchange reserves during upswings in the exchange rate cycle and using them in times of need.

Thank you.