Már Guðmundsson: Economic outlook, monetary policy, and credit ratings

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the Chamber of Commerce Monetary Policy Meeting, Reykjavik, 6 November 2014.

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Madame Chairman, honoured guests,

The Iceland Chamber of Commerce has a long-standing tradition of holding a meeting like this one on economic developments and prospects and monetary policy. The meeting is held following the publication of the Central Bank's autumn forecast and, in latter years, the Monetary Policy Committee's interest rate decision. It often has an additional specific topic, and on this occasion, our hosts have expressed an interest in the outlook for credit ratings. I will touch on that towards the end of my talk today, but as I usually do, I will focus mainly on monetary policy and the current and future economic situation.

The big picture regarding the economy is this: the recovery that began in Q2/2010 is now well enough advanced that the slack in the economy is almost fully absorbed. The domestic economy has seldom been as well balanced as it is now. There is internal equilibrium, in that inflation has been at or below target for nine months and output is close to capacity. And there is external equilibrium, in that we have had a sizeable current account surplus that covers net capital outflows with room to spare, as the Central Bank has bought foreign currency for a total of 95 b.kr., or 5% of GDP, so far this year.

According to the Bank's forecast, the near-term outlook is positive. GDP growth is projected to measure just under 3% this year and then rise to about 3½% in 2015 before tapering off again to 3% in 2016. This level of growth is expected to exceed that of potential output with the effect that a positive output gap might emerge, particularly in 2015. Other things being equal, this will contribute to higher inflation.

GDP growth in 2014–2016 will be driven by domestic demand, both private consumption and investment, and the contribution from net trade will be negative for the entire period. As a consequence, the sizeable current account surplus we have seen in the recent term will shrink rapidly next year and give way to a small deficit in 2016. This is cause for concern in and of itself, and we hope that the forecast will not materialise, as Iceland needs to maintain a current account surplus in the next several years as it focuses on putting its external debt onto a stronger footing and building up domestically financed foreign reserves. Economic policy and economic incentives would then have to take into account the task of of improving the outlook for the current account balance.

Inflation has been below the inflation target for nine consecutive months. This is the second-longest such period since the inflation target was adopted in March 2001, the longest being a twelve-month period from November 2002 through October 2003. But it is not inconceivable that we might break that record, as the Bank's forecast, published yesterday, entails that inflation will remain below target through the early months of 2015.

Inflation below target is not more desirable than inflation above target, though. In this context, we mustn't fall into the trap of expecting monetary policy instruments to be so strong and quick-acting that inflation will always measure 2.5%, no matter what shocks hit the economy. The main objective is to keep average inflation close enough to the target over a long period of time that the target itself provides an anchor for inflation expectations and the many decisions that require an estimate of future inflation.

But how close is close enough? In this context, our so-called tolerance limits for the inflation target – namely, 1% and 4% – are too wide, and it is worth noting that those limits are merely the trigger for the submittal of a report to the Government explaining how inflation will be brought back to target. In short, then, the inflation target is not 1–4%. In order to underline the control problem, I sometimes say that the inflation target is not 2.5% but 2½%. What this means is that, if we think in whole and half percentage points, a deviation of half a percentage point or less from target would be considered within the boundaries of target-level inflation. By that criterion, inflation as projected in the Bank's forecast will be at target for the entire forecast horizon through end-2017, apart for the last quarter of 2015 and the first quarter of 2016. According to the forecast, inflation will average 2.6% during the period 2014–17 and will therefore be at the 2½% target. If this materialises, it is hard to call it anything other than an acceptable performance.

It is naturally less of a concern if inflation deviates temporarily from target if inflation expectations do not deviate in the same direction. Early this year, inflation expectations were above target even though measured inflation was below it. But fortunately, inflation expectations have subsided towards the target in the recent term and, by some measures, are close to it, particularly short-term expectations. This is important for monetary policy, as I will explain shortly.

I have briefly discussed the current situation and the economic outlook. But what about uncertainties and known risks?

There are risks attached to the global economy, which seems to be on the downside, at least in the near term, as regards both output growth and inflation. And there is the risk that our economic policy and contractual wage negotiations will not be successful, as has so often been the case during upswings. GDP growth will then be somewhat stronger in the short run, but the current account balance will deteriorate and inflation will rise, and ultimately GDP growth will fall below what it would have been otherwise.

There is uncertainty about the exchange rate, in connection with the settlement of the failed banks' estates and the liberalisation of the capital controls. There is little I can say about that at this point, but the aim of the work the authorities are doing at present is to minimise that risk. It can be done, but it is a risky process, and one that could be derailed at many points along the way if great care is not taken – and perhaps even if great care *is* taken.

And now I will turn to monetary policy. Yesterday the Monetary Policy Committee decided to lower Central Bank interest rates by 0.25 percentage points, in view of recent developments and the near-term outlook for inflation and the decline in inflation expectations, which I mentioned a moment ago. If the Bank's interest rates had remained unchanged, its real rate would have been higher than is warranted by where we are in the economic cycle and by the near-term outlook, particularly in view of the fact that it could rise still further in coming months.

Estimating the Central Bank's real rate is not always a simple matter, as different measures of inflation and inflation expectations give differing results. According to an estimate based on the average of various measures of inflation and inflation expectations, the Bank's real rate was about 2½% before the recent reduction, and it had risen by approximately a percentage point in the previous year, which is a large change in terms of real rates. It could be argued, too, that this is more likely an underestimation than an overestimation, as there is systemic positive bias in household inflation expectations and the breakeven inflation rate in the market entails risk premiums.

The effect that the real rate has on domestic demand and inflation depends on what the equilibrium real rate is considered to be at any given time; that is, the real rate that neither stimulates nor dampens the economy. The equilibrium real rate has probably fallen in Iceland, as it has in most economies in the wake of the financial crisis, but exactly where it lies is highly uncertain. One of the Monetary Policy Committee's tasks is to attempt to assess it. It is normal that Central Bank interest rate should rise above equilibrium when a positive output gap develops and inflation is above target, but neither is the case at present. That being so, it was appropriate to contain the rise in the real rate by lowering the Bank's nominal interest rates.

Some will surely ask: Shouldn't the Bank have lowered interest rates earlier? Hasn't the monetary stance simply been too tight in the recent past? I don't think this is the right time to dissect these questions, not least because many things look different in the rear-view mirror. As is said in *Njáls saga*, "Everything is ambiguous in retrospect." That said, I think there are solid arguments in favour of a negative response to both questions.

As regards timing, it is worth mentioning that it was not until very recently that inflation expectations have moved as close to target as they are now. As regards the latter question, most measures of the monetary stance have been well within normal range for quite a while, and there are few other signs that it has been too tight, expect perhaps in the past few months. For example, nominal growth in broad money measures about 6% after adjusting for factors that are largely unconnected to domestic economic activity, such as deposits of failed financial institutions in active ones. This growth is consistent with the situation that should exist when the economy is at equilibrium – when inflation is at target and output is at capacity.

An examination of nominal GDP growth gives a similar result. Based on forecasts for 2014, it will average 5% in Iceland over the period 2011–2014, as compared with just under 4% in the US and the UK, about 2½% in Sweden – which is just above the inflation target alone– and about 1½% in the euro area, which is even below the inflation target for the region. This has been used to support the argument that monetary policy has been too tight in the euro area and Sweden, but as the figures show, this rationale does not apply to Iceland.

And last but not least, GDP growth has been relatively robust and the margin of spare capacity in the economy has been disappearing at the same time as inflation has been trending towards target. Many observers would consider this to be evidence that monetary policy has hardly been on the wrong track.

Yesterday's announcement that future interest rate movements would depend on wage developments in the labour market seems to have drawn some attention. But there seems to be some misunderstanding about what this means. Over time – but not necessarily at every moment in time – wages in the labour market as a whole – but not necessarily for each group – should rise by an amount equal to the inflation target plus productivity growth. How much this is depends, then, on productivity growth. At present, productivity growth appears to be low – about 1%. This means that the scope for wage increases consistent with the inflation target is 3.5%. What that means for wage settlements depends on the degree to which wage drift can be contained.

Some groups could receive larger pay rises than this, but then others would have to have smaller increases. Sometimes there are grounds for this. Then it is important to bear in mind that this is a long-term relationship. For a period of time – even perhaps a few years – wages can rise somewhat more without jeopardising the inflation target – for example, if the ratio of wages to national income is unusually low following a crisis and businesses are able to absorb some of the increase. This has been the case to an extent in the past few years. Other factors could counteract larger wage increases as well – for instance, declining foreign-currency prices of imports and a stronger króna have contributed to declining inflation even though wages have risen considerably more than the sum of the inflation target and the increase in productivity.

But there are a number of indications that we will not be able to rely on these countervailing factors next year. By then, the slack will have disappeared from the economy, the ratio of wages to national income is at or above its historical average, and there are no premises for further appreciation of the króna, as the current account surplus is narrowing and the real exchange rate is no longer below its estimated equilibrium value. Nevertheless, different wage increases could be negotiated for different groups if there are grounds and will to do so.

As I draw near the conclusion of my talk today, I would like to shift gears a bit and say a few words about credit ratings. When all is said and done, the primary objective of a credit rating is to estimate the probability that a borrower will service its debt in full and on time. This probability depends on two factors – the ability to pay and the willingness to pay – which, as history has shown us, are not necessarily one and the same, as could maybe be seen in the examples of Finland and Argentina.

Sometimes it seems as though rating agencies exceed their mandate and act as though they are purveyors of some sort of Good Housekeeping seal of approval for economies and governments. For example, one could ask what the Republic of Iceland's probability of default is, since the country didn't default during the financial crisis.[1] While it is pointless to debate this fact with them, it actually, seems to me that a number of improvements have taken place in the wake of the crisis. Upon closer examination, much of what rating agencies take into account is clearly related to developments in both ability and willingness to service debt. Among the factors they consider are debt levels and guarantees, GDP growth potential, the size and structure of the economy, and other factors that affect vulnerability to shocks, institutional quality, governance and policy continuity, and political risk. This gives some indication, of course, of which factors are a drag on Iceland's credit rating at present, and how they could be addressed.

Iceland's sovereign credit rating soared during the years before the crisis, and Icelandic banks' credit ratings followed in its wake. In fact, perhaps they rose higher than was warranted and was good for us. In spite of the ensuing nosedive, we managed to keep the sovereign rating on the bottom rung of investment grade, apart from two years in Fitch Ratings' speculative category after the first Icesave referendum.

Keeping Iceland's ratings in the investment-grade category cost an incredible amount of effort, and other countries that have gone on an IMF programme in recent years have seen their ratings from Moody's and S&P fall to speculative grade. Some of them have managed to rise up faster than Iceland has, however.

Studying the rating agencies' reports shows which factors will be most important in order to improve Iceland's sovereign rating and thereby pave the way for the banks to follow suit. Among them are continued reduction of public debt levels and sound, focused economic policy that provides stability throughout the ongoing upswing. The liberalisation of the capital controls is an extremely important factor, but it could work both ways. Successful moves towards liberalisation without jeopardising stability will have a positive effect, but disturbance of economic and financial stability will do the opposite.

My assessment of this, and of conversations with the rating agencies, is that it is probably not realistic to expect an improvement in our sovereign rating in the very near term. But if we can preserve stability and GDP growth next year while demonstrating that we can at least begin lifting the capital controls without compromising stability and confidence, our chances for a higher credit rating should improve markedly.

Thank you.

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1 For further information, see: the Governor's comments at a panel discussion held at a BIS symposium entitled *A world without risk-free assets?* Bank for International Settlements, Basel, 8–9 January 2013. See: here.