Monetary policy: achievements and review?

Már Guðmundsson, Governor of the Central Bank of Iceland. Monetary policy meeting of the Iceland Chamber of Commerce, held at Harpa in Reykjavík on 17 November 2016

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. In recent years, it has been the practice to select a particular topic for the meeting, and in keeping with this, today's topic is: Is independent monetary policy too costly? This departs somewhat from the contents of the Central Bank's *Monetary Bulletin* and current tasks of monetary policy, but I will touch on these towards the end of my speech today.

Yesterday the Bank published *Monetary Bulletin* 2016/4, which contained the Bank's new macroeconomic forecast, and announced the Monetary Policy Committee's interest rate decision. The big picture of the current state of the economy is that things have seldom been better. Icelanders have received a significant boost from improved terms of trade and growing goods and services exports, particularly due to strong growth in the tourism sector. It is this that underlies the vast increase in Icelanders' real income and the country's high employment level. In addition, Icelanders have proven more cautious this time than often before during an economic boom. Debt levels continue to fall, and the propensity to save is considerably stronger than has usually been the case during post-World War II upswings. This is probably due in part to greater caution in the wake of the financial crisis, but tight monetary policy has been a factor as well, by contributing to slower demand growth than would otherwise have been the case and by shifting a part of the steep rise in income and wealth towards saving. All of these factors have pulled together to create a better balanced economy than I have seen in my entire career. We have a handsome surplus on the current account of the balance of payments. Inflation has been below target for nearly three years in spite of large pay increases and strong demand growth. Positive supply shocks and the resulting currency inflows play a role here, and so does importation of labour. As a result, imported deflation and the appreciation of the króna have proven stronger than the inflationary pressures from the domestic labour market. Monetary policy has pulled in this direction as well, as I

mentioned, and in a historically important development, inflation expectations are close to target by most if not all measures.

If this continues, monetary policy will have greater scope to mitigate the impact if positive developments give way to negative shocks. And according to the Bank's baseline forecast, the outlook is good: continued strong GDP growth and full employment; a current account surplus throughout the forecast horizon; the prospect that Icelanders will soon own more assets abroad than foreign nationals own in Iceland; and inflation at target for the entire period.

One can ask, in view of this, why some observers are so dissatisfied with monetary policy. I will discuss this in more detail later on. But there are significant risks, and we must be on the watch for them. There is an obvious risk of economic overheating. The labour market could spiral out of control. Economic policy mistakes could take place – for instance, if fiscal policy begins to pull too strongly in a different direction from monetary policy. We have seen the repercussions of this before.

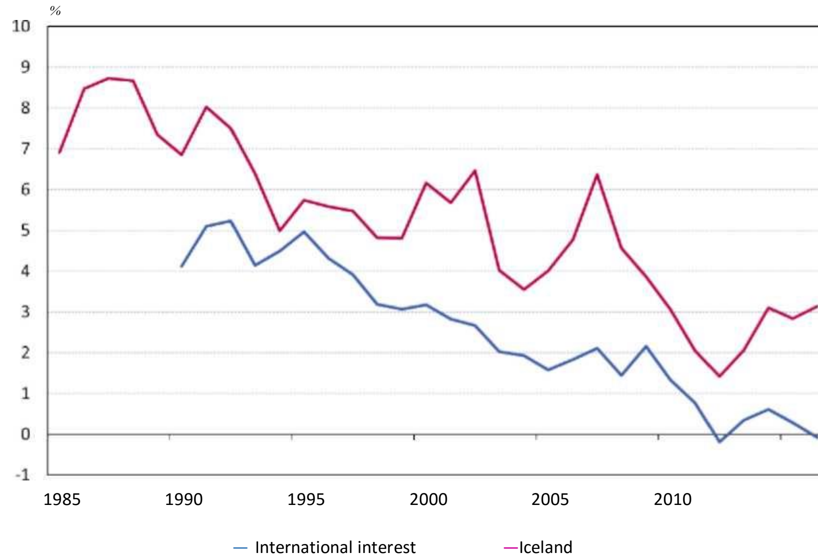
I will now turn to the main topics of my speech today: the level of interest rates in their long-term context, the foreign exchange market, and possible changes to the monetary policy framework.

Level of interest rates

During the run-up to the recent Parliamentary elections, there was considerable discussion of the level of interest rates in Iceland. If we are to come to a sensible conclusion on whether the nominal interest rate set by monetary policy is appropriate or not in terms of inflation, inflation expectations, the business cycle, a plausible estimate of the equilibrium real rate, and foreign interest rates, it is important that the discussion be based on facts. When we consider the interest rates that are most important for households and businesses – i.e., longer-term real interest rates rather than the rates decided directly by the Bank – it is also important to realise to what extent monetary policy can affect those rates. The answer to this is that monetary policy only has a short-term impact on long-run real rates that are ultimately determined by underlying economic fundamentals, not least the interactions between the propensity to save and the impetus to invest.

Let us now examine a few facts of importance in this context. First, it should be noted that international long-term real rates have been falling over the past three decades, as can be seen in Chart 1.

Chart 1: Real long-term Treasury rates on price indexed bonds 1985-2016



Rates on indexed long-term Treasury bonds (5-10 years). International interest rates are the simple average of rates for the US (from 1999), the UK, and Germany. The Icelandic data are compiled from data on initial offerings of Treasury savings bonds and yields on Housing Financing Fund bonds and indexed Treasury bonds. The figure from 2016 is the average through mid-November.
Sources: Bank of England, US Federal Reserve Bank, Central Bank of Iceland.

This development began long before the financial crisis. The crisis, the ensuing economic contraction, and the monetary easing in response to the crisis amplified this tendency still further, and long-term real rates are now at an absolute historical low. In part, this is related to the business cycle position in larger advanced countries and could turn around in coming years. However, it is unlikely that the decline in real rates over the past few decades will reverse to any large degree in the near future.

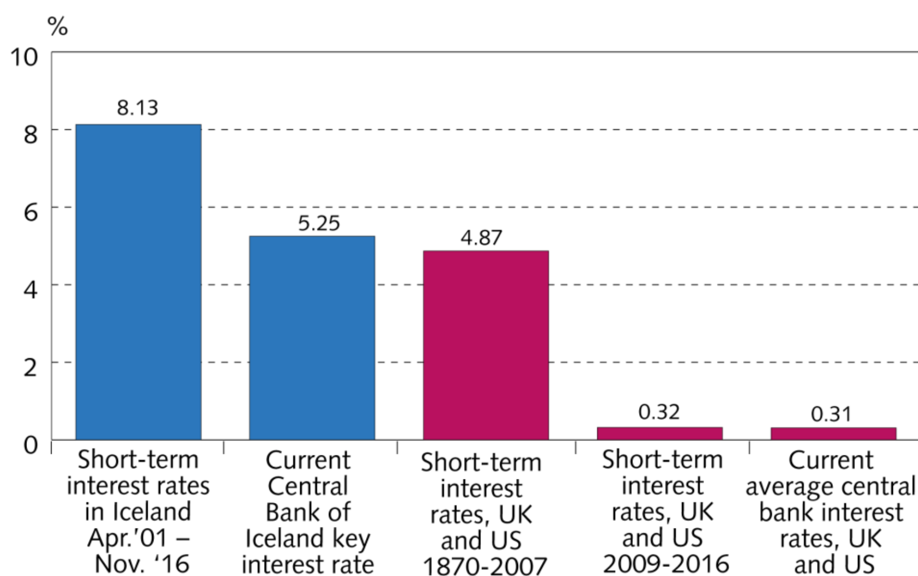
One of the main theories in conventional economics is that monetary policy cannot affect real variables – including long-term real interest rates – except temporarily. Although this is something of a simplification, and it is possible that monetary policy that is either far too tight or far too loose over a long period could have more of an impact than this, particularly in an economy with major imbalances, the theory is nevertheless a close enough approximation under normal circumstances to take account of it here. The period under scrutiny is too long for monetary policy to have had a substantial impact on developments. Furthermore, it is clear that the tendency to cut interest rates is not limited to individual countries; it is an international pattern, although it surfaces to varying degrees in different countries. Therefore,

the explanations will most likely be found in factors affecting the propensity to save, the willingness to invest, and weaker growth in potential output globally. All three of these have contributed to lower real rates over this period, although reduced growth in potential output might be more recent. The aging of the population, increased public saving in emerging countries (including the accumulation of foreign exchange reserves), and increased income inequality within countries are among the factors that have contributed to the increase in the propensity to save. Declining relative prices of investment products and increased uncertainty and risk aversion, particularly during the aftermath of the crisis, have negatively affected the willingness to invest.

But how does Iceland fit into this picture? As Chart 1 indicates, developments here have been similar, although interest rates have been – and still are – higher than in larger industrialised countries. This is quite at odds with what could be expected based on some of the discussion taking place in Iceland. The fact is that long-term real rates in Iceland are currently at their lowest for this entire period, apart from a short time in the midst of the economic crisis, when the real policy rate was held very low so as to stimulate the economy and presumably pulled longer-term rates downwards for a while.

I have said that monetary policy had little to do with these developments. This does not change the fact that these developments have affected monetary policy, as they reflect in part the decline in short-term equilibrium real interest rates. Monetary policy has therefore responded to this with lower nominal interest rates than would otherwise have been appropriate. Nominal rates have fallen even further during this period, for three reasons. First of all, inflation and inflation expectations were brought to target levels in major industrialised countries in the last two decades of the 20th century; therefore, it was not necessary to keep nominal and real rates as high as before. It could be said that the same development has taken place here in Iceland in the recent term. Second, global deflationary tendencies have been strong in recent years, following the inclusion of China and Russia in the global trading system and due to technological advances and developments in international production and value chains. Third, a pronounced economic slack in major industrialised countries after the financial crisis has led to much more accommodative monetary policy than would otherwise have prevailed in those countries. All of these factors combined have contributed to the current situation, where nominal central bank rates in leading industrialised economies are extremely low in historical terms. Actually, many observers consider them dangerously low as regards their potential impact on financial stability and the efficacy of the financial system.

What about Iceland in this context? The Central Bank's key rate is the interest rate that determines short-term market rates at any given time. In the recent past, this has been the rate on seven-day term deposits, which is now 5.25%, as Chart 2 indicates. It is far below the average for the period since the adoption of the inflation target in late March 2001, in spite of the significant tension in the economy. This is a reflection of the progress made in the recent term in bringing inflation expectations to target. The Bank's key rate has been slightly lower on two occasions since the adoption of the inflation target: in early 2011 and in early 2015. It peaked at 18% in late 2008. It is therefore incorrect to say that the Bank's key rate is always high, no matter what the economic situation. Nor is it appropriate to say that the Bank's interest rates are off the charts in the context of Iceland's economic history: quite the contrary.



Sources: Jorda, O., M. Schularick, and A. M. Taylor (2014). "The great mortgaging:Housing finance, crises, and business cycles", National Bureau of Economic Research, NBER *Working Paper* Series, no. 20501, Central Bank of Iceland.

It is also interesting to compare domestic interest rates with historical interest rates in developed countries. The chart shows that the average of short-term nominal interest rates in the US and the UK was slightly below 5% over the period from 1870 through 2007. This is not far from the short-term nominal rate in Iceland at present, and it should be noted that we are in that part of the economic cycle where the output gap is positive, whereas the business cycle tends to average out over such a long period as is shown in this chart. However, post-crisis interest rates

in these countries are far below their previous historical low and therefore much more "off the charts" than Iceland's. There could be sound reasons for this, although opinion is divided on the matter.

Let us examine Iceland's current interest rates more closely, ignoring for the moment the problems associated with pursuing independent monetary policy in small, open economies with unrestricted capital flows, which I will mention later. Let us also assume that inflation expectations remain at target, as they are at present. The question of whether or not a nominal policy rate of 5.25% is appropriate then centres on what is considered to be the equilibrium real policy rate; i.e., the interest rate that would keep inflation at target when the economy is in balance. With inflation expectations at 2½%, the real policy rate is currently just over 2½%. Before the financial crisis, the equilibrium policy rate was estimated to be quite a bit higher. As is the case elsewhere, it has probably fallen in the wake of the crisis. Furthermore, recent success in monetary policy may mean that we do not need as high an interest rate as before to keep inflation at target. We do not know how much the equilibrium rate has fallen, although the subject has been under close scrutiny within the Bank and has been discussed repeatedly at Monetary Policy Committee meetings. The newest research on the assessment of the equilibrium real rate will be presented at a seminar held at the Central Bank on 29 November.

Perhaps there will be scope in the future to lower the short-term real rate as measured by inflation expectations somewhat further. This will depend on developments, including exchange rate developments and the stance of other economic policies. In addition, nominal interest rates could change in response to developments in inflation and inflation expectations. Under current conditions, however, it must be borne in mind that the economy is not in balance but in the boom part of the cycle. Furthermore, the contribution from other economic policies is uncertain at the moment because a new Government has yet to be formed after the Parliamentary elections and next year's fiscal budget proposal has yet to be presented. Moreover, it is too early to say what the impact of capital account liberalisation is. One thing is certain, however: if steep interest rate cuts are made without being warranted by economic conditions, it is clear that the real rate would decline for a while. But because credibility would undoubtedly suffer as a result of poorly grounded measures of this type, it would have to rise again, to a higher level than before, and for a longer period than would otherwise have been needed to bring inflation and inflation expectations back down to target.

Is it a lost cause, then, that Iceland's interest rates might with time become similar to those in trading partner countries? Not at all. First, we must hope, for their sake, that neighbouring countries will not need to

maintain such abnormally low interest rates for the long term. Second, the longer we keep inflation expectations at target, maintain a current account surplus, and continue to pay down debt, the more the risk premium component of interest rates and the equilibrium real rate in Iceland will continue to fall. The current propensity to save, adjusted for the business cycle position, is much greater than it has been for quite a while, and over time, it will contribute to a reduction in the long-term equilibrium real rate. If inflation expectations remain at target, both nominal and real rates will decline accordingly.

Exchange rate of the króna and Central Bank foreign currency purchases

Responding to the recent strong inflows into the foreign exchange market is one of the Central Bank's most complex tasks at present. The problem lies, among other things, in distinguishing between short-term inflows, which are only loosely connected to economic fundamentals and are much more likely to stop suddenly or even reverse, and inflows that reflect more lasting positive changes in fundamentals, although these can change for the worse as well. It can be argued that, other things being equal, there should be more foreign exchange market intervention in the former instance and less in the latter.

While the foreign exchange reserves were being increased to the desired size during the prelude to general capital account liberalisation, this distinction was less important for policy responses than it is now, as the premises were in place to buy the inflows and top up the reserves, more or less irrespective of the origins of the inflows. Carry trade-related inflows into the bond market did cause some disruption of monetary policy transmission in summer 2015 and last winter and could have posed risks for financial stability further ahead. For this reason, and also to prevent the development of a new "overhang" following the offshore króna auction in June 2016, it was considered appropriate to take action to mitigate these inflows. Since then, they have largely stopped. However, there has been no let-up in foreign currency inflows in recent months, and by the end of last week, the Central Bank had bought foreign currency in the amount of 160 b.kr. since the beginning of July and the exchange rate had risen by nearly 12% over that same period.

The available data indicate that foreign currency inflows are to a large extent related to the trade surplus, which has been quite large, owing partly to growth in tourism and positive terms of trade, plus foreign investors' increased interest in direct investment in the Icelandic economy. The banks' and other Icelandic firms' improved access to foreign credit could play a role as well. On the other hand, speculative

flows related to the interest rate differential appear to account for only a small part of the inflows. Another important factor is that liberalisation-related outflows are still limited. It should be noted, though, that balance of payments figures for Q3/2016 could change the picture somewhat, but they will not be available until the beginning of next month.

The Central Bank has bought a smaller share of foreign exchange inflows in the recent past than it did earlier in the year, and the króna has appreciated more as a result. This is because the foreign exchange reserves are larger and somewhat above the recommended minimum for liberalisation of the capital controls. The nature of the inflows is important, as is the view that if the currency appreciates due to a rise in the equilibrium real exchange rate, this is part of the desirable countercyclical role of the exchange rate; furthermore, it is not desirable to disconnect the exchange rate channel of monetary policy transmission entirely. Nevertheless, the foreign currency purchases have been substantial, based on precautionary principles concerning the durability of the inflows and attempts to prevent excessive appreciation of the currency in advance of liberalisation-related outflows.

In the wake of the Central Bank's large foreign currency purchases this year, the question has arisen whether large foreign exchange reserves are a problem in and of themselves; i.e., whether they jeopardise the Bank's finances to such a degree that they could undermine its ability to pursue appropriate monetary policy at any given time. We do not have time to explore this in depth here, but the short answer is: no, they are not. First of all, we must not focus only on the cost of financing the reserves; we must also consider the benefits associated with them. Second, in assessing the current size of the reserves, it is important to bear in mind that the impact of general liberalisation of capital controls seems, fortunately, to come to the fore gradually, although this does not mean that it couldn't become significant going forward. Large reserves generate confidence during this process. Third, we should not project current conditions to the infinite future and therefore come up with a huge problem. The monetary stance changes over the course of the business cycle, as is normal, and the interest rate differential with abroad varies from one point in time to another. Furthermore, there are fluctuations in foreign currency flows and exchange rates, and the opportunity could arise later to sell off a portion of the reserves so as to mitigate these fluctuations and generate revenues to offset the current cost of the reserves.

None of this changes the fact that we must always think in terms of reducing the cost of financing the reserves. Larger reserves provide for the possibility of placing a portion in riskier investments that could generate larger returns, as many central banks in a similar position have done in recent years. It is also possible that, in addition to the distribution

of the costs and benefits of the reserves, which is built into the current regulatory framework for the financial interactions between the Treasury and the Central Bank, ways could be found for banks and even other financial institutions to participate in the cost of financing the reserves, as these institutions enjoy the benefits of them, including better credit ratings and lower foreign financing costs. The worst that we could do in this context would be to sacrifice the long-term benefits of price stability and economic equilibrium in order to increase the Central Bank's profits in the short-term.

The monetary policy framework

I would now like to turn to two related topics: the pros and cons of independent monetary policy, on the one hand, and possible changes to the monetary policy framework and implementation, on the other. I must be brief because the clock is ticking, but I am more than willing to answer questions about this and other points later on.

"Is independent monetary policy too costly?" is the topic of this meeting. Presumably, the question implied is whether the benefits of such monetary policy are outweighed by the costs. To my mind, this question can hardly be answered without reference to the various options available because we must have some sort of currency regime, and all of them have pros and cons. If there is a currency union, it is the monetary policy of the union's central bank that carries the day. In the case of the eurozone, that is the European Central Bank. The pros and cons of such cooperation were outlined in detail in a report published by the Central Bank in autumn 2012, and I do not have time to cover them here.[1] If we continue with our own currency, the question of exchange rate policy arises: should the króna be pegged against one currency or a basket of currencies, should it float freely, or should it be somewhere in between? If the exchange rate is pegged, it is not possible to apply monetary policy to mitigate economic fluctuations by responding to shocks. The adjustment will therefore take place more through fluctuations in employment and output and less through fluctuations in real wages than is the case with independent monetary policy and a flexible exchange rate. What do we want in this context? A good stylised example of how independent monetary policy and a flexible exchange rate could mitigate the impact of shocks on employment and output can be found in the most recent issue of *Monetary Bulletin*, which describes what would happen if the past few years' improvement in terms of trade should reverse with

[1] http://www.cb.is/publications-news-and-speeches/publications/special-publications/special-publication-7/

a reduction in marine product prices.[2]

There are many things to consider in this respect. Experience shows that in small, open economies with unrestricted capital flows and a free-floating currency, the exchange rate has a tendency to fluctuate excessively and irregularly, with possible negative implications for financial stability. And as is discussed in the aforementioned Central Bank report, such exchange rate volatility can sometimes be a source of economic volatility. Furthermore, as examples have shown, lack of fiscal discipline together with overly loose financial regulation and lax supervision can undermine independent monetary policy with either a floating or a fixed exchange rate, even if the latter takes the form of a currency board.

The "capital flow problem", as we could call it, lies in capital inflow surges based on excessive optimism and underpricing of risk – capital inflows that then stop and reverse, with fire and brimstone and severe repercussions for economic and financial stability. Experience shows that this problem is not limited to countries with a floating exchange rate – quite the contrary, in fact. Countries with a pegged exchange rate have suffered severely from just such a scenario, as have countries within the euro area. This problem was a key player in the crises in Greece and Spain, to give two examples. As a consequence, there is no less need for so-called macroprudential tools in countries with a pegged exchange rate or countries in a currency union than there is in countries with independent monetary policy and a floating currency. Some view foreign exchange reserves as the cost of pursuing independent monetary policy. This is not entirely correct because any country with its own currency must hold foreign exchange reserves, and it is easy to demonstrate that the reserves must be larger under a pegged exchange rate than under a floating exchange rate.

I could continue to beat the drum on simplifications and magic solutions. The main thing, though, is that selecting a currency and monetary policy regime is not as simple as it is sometimes made out to be. And it is not merely a question of which policy is best if implemented perfectly – because implementation is never perfect. Mistakes are made, and then it matters how robust the systems are in the face of such mistakes, and what scope there is to correct them without overstraining the systems.

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[2] *Monetary Bulletin* 2016/4, p. 12-14.
http://www.cb.is/publications/publications/publication/2016/11/16/Monetary-Bulletin-2016-4/

Conclusion

In view of the discussion of monetary policy that has taken place recently – not least during the run-up to the Parliamentary elections – I consider it necessary to engage in continued thoughtful discussion of what type of monetary policy framework will be most appropriate once the capital controls have been lifted, as we are not members of a currency union. Many attempts have been made in this regard, and the Central Bank has published a range of material on the topic. In my opinion, the monetary policy that has been developing in Iceland during the aftermath of the crisis – a monetary policy framework that is quite unlike its pre-crisis counterpart – has delivered good results in the recent past and is a viable candidate for the future. But perhaps it is like Groundhog Day: with each new beginning, we come closer to the solution. Let us hope so.

If we play our cards right, the benefits of independent monetary policy could outweigh the costs. That does not necessarily mean that it is the best of all possible options. Some type of peg is also a possibility that could be explored, although it, too, has pros and cons, like all others. The Swedes raised their policy rate to a high double-digit figure in order to defend their peg, and at one point the policy rate was raised to 500%. The British raised their interest rates to 15% for the same reason. In neither instance was this sufficient, however, because other foundations were no longer in place. Hong Kong managed to defend its peg during the Asian crisis but had to raise rates significantly and resort to a range of unconventional measures, including large-scale intervention in the equity market.

The main conclusion is that neither a pegged exchange rate nor independent monetary policy with a flexible exchange rate will generate the intended results unless several other things are in place: policy instruments designed to achieve those results must be applied as needed, other economic policies should be aligned with monetary policy objectives, and prudential policy regarding the financial sector must support rather than undermining economic stability.