



30 March 2017

## Speech

Már Guðmundsson, Governor of the Central Bank,  
delivered at the 56<sup>th</sup> Annual Meeting of the Central Bank of Iceland, 30 March  
2017.

Prime Minister, Minister of Finance and Economic Affairs, Speaker of  
Parliament, bank directors, foreign ambassadors, ladies and gentlemen!

We have come together today for the 56<sup>th</sup> Annual Meeting of the Central Bank of Iceland. At the time of last year's meeting, the domestic economy was considered relatively strong. GDP had risen above the pre-crisis peak. National income had risen even more in recent years because of improved terms of trade. Unlike many previous periods of full employment, the economy was well balanced internally and externally, as could be seen in a two-year period of inflation at or below target and a sizeable current account surplus. This was a good position, but we also realised that it could be fragile, as demand pressures were mounting and there was a real risk of overheating. Developments internationally had been favourable for us in many ways, but the tide could turn. We therefore needed to be on the watch, and economic policy had to take this risk into consideration.

Then what do we say now, when growth has accelerated even further and demand pressures are even greater, yet inflation has remained below target, inflation expectations have subsided to target, the 2016 current account surplus was at a historical high, and we own more than we owe abroad? In addition, the policy interest rate was lowered by 0.75 percentage points last year, the króna has appreciated by over 16%, the Central Bank has bought more than 350 b.kr. worth of foreign currency, the foreign exchange reserves have grown by over a third in foreign currency terms, and capital controls have been almost completely lifted in three large steps. These are substantial changes in a single year – changes that will presumably take their place in economic history.

What lies behind these developments? How could the domestic economy grow by more than 7% in 2016 without overheating and unleashing inflation? Five major factors are presumably of considerable significance whose mechanism it is important to understand in order to assess what comes next and formulate appropriate economic policy responses.

First of all, the supply side of the economy is more flexible than before, owing to increased economic integration with the rest of the world. The EEA Agreement plays a large role here, but so do other trade related agreements and

general market-driven developments in the global economy. Because of this, when demand pressures start to develop, it is easier than before to mitigate them: by importing labour and other production factors, by using foreign inputs in domestic production chains to a greater degree, or by moving a portion of operations out of the country. Last year, for instance, net migration among foreign nationals was closing in on the previous peak from 2006.

The second important factor is understanding the nature of the largest shock to the economy in the recent term and how it interacts with the countercyclical role of the exchange rate. The surge in tourism has been one of the main drivers of GDP growth in recent years. In part, the tourism industry utilises infrastructure and capital that were underutilised before growth in tourism took off; therefore, the impact on the level of domestic demand was less pronounced than it would have been if the surge had necessitated an immediate increase in investment. Now, however, we have probably reached the endpoint as far as this is concerned. In addition, increased tourism brings with it foreign currency inflows that, other things being equal, will push the exchange rate upwards. This will cut into activity elsewhere, shift demand outside the domestic economy, and reduce inflation. To a degree, then, after full employment is reached, an automatic counterweight develops, offsetting the pressures caused by growth in tourism.

Third, global economic developments have remained favourable to us. Terms of trade for goods and services have improved in recent years, and foreign currency prices of imports have fallen.

Fourth, a larger share of income is being channelled towards savings than has often been the case in the past. Last year, gross national saving – the share of GDP not used for private or public consumption – was nearly one-third of GDP, one of the highest national saving rates in our history. This high level of saving explains why last year's current account surplus was so large even though investment had returned to its historical average. Underpinning it is increased saving by households, businesses, and the public sector, which in turn stems from several factors: increased caution following the experience of the financial crisis; an improved public sector outcome; the housing market situation, where more capital is required for a first home purchase; and the level of interest rates. A higher level of saving reduces excess demand in the economy.

The fifth factor is the success of monetary policy in the recent term. This can be seen in short- and long-term inflation expectations, which have been at target since mid-2016. In addition, expectations appear more firmly anchored to the target than before, which shows in the fact that exchange rate volatility and unexpected changes in inflation have less impact than they did in the past. The inflation target has therefore gained credibility. As a result, it takes more to move inflation away from the target than in the past, and inflation can be kept at target over the medium term with lower interest rates than was previously possible. By the same token, the possibilities for monetary policy to mitigate fluctuations in economic activity without jeopardising the inflation target are greater.

What is the current situation, in light of these explanations? In some respects, the current situation is similar to that a year ago. For this year, it is forecast that GDP growth will remain well above long-term growth in potential output and demand pressures will still increase, but that inflation is projected to remain below target for most of the year. This is uncertain, however, and various changes have taken place and others may lie ahead, which could affect future developments. The tradable sector is now experiencing stronger crowding-out effects from tourism, after the rapid growth of the latter in recent years. Sizeable pay increases in the recent term and last year's strong appreciation of the króna cut into profits, and companies now have less scope to absorb pay rises. The recent appreciation of the króna is a result of growth in tourism and other favourable developments, and it tends to shift demand outside the domestic economy, thereby reducing the positive output gap.

Although forecasts based on given assumptions and available models indicate that the exchange rate will continue to rise, it should be noted that this is highly uncertain. Capital account liberalisation could contribute to either a higher exchange rate or a lower one in the short run, depending on how expectations develop. The special reserve requirements imposed last June on capital inflows to the bond market and high-interest deposits have contained the rise in the exchange rate and will reduce the likelihood of a steep carry trade-related appreciation in the near term. From 12 March, when capital account liberalisation was announced, through yesterday's official listing, the exchange rate of the króna had fallen by 3.8%.

At present, there are changes taking place in the global economy that will change the situation to some extent. Global GDP growth is on the rise, particularly in industrialised countries. Commodity prices are rising, and inflation in industrialised countries appears to be increasing as well. Interest rates have been raised in the US, and the period of very low or even negative interest rates in the euro area may be coming to an end. This has various effects on the Icelandic economy. It is not a given that terms of trade will continue to improve, and imported deflation will subside as well. Domestic inflation could therefore rise above target more quickly unless domestic pressures ease commensurably. On the other hand, the interest rate differential with abroad will narrow, other things being equal, and this will make the conduct of monetary policy less difficult and reduce the Central Bank's accounting loss due to the foreign exchange reserves, as I will discuss more fully in a moment.

Monetary policy conduct is generally much more complicated during times of significant change than under calmer conditions. The signposts of the policy – such as equilibrium interest rates, output, unemployment, and the exchange rate – could begin to move. However, because these variables are not observable but must be derived from developments in other variables, it is highly uncertain at any given time how much they have changed once they start to move. Furthermore, relative prices change more than they did before, but monetary policy cannot affect them except in the short term. Sometimes it can be difficult to distinguish between such relative price changes and a general rise in the price

level, which depends in the long run on monetary policy. In addition to this, it can often be difficult to determine at any given time which changes are temporary and could possibly be mitigated through economic policy and which ones are more permanent and nothing much can be done about, at least through monetary policy.

These are exactly the conditions we are experiencing at present. There are clear indications that the equilibrium real exchange rate has risen with improved terms of trade, increased national saving, and a vastly improved external position. In addition, there are indications that equilibrium interest rates have fallen since before the crisis, and they have probably fallen still further as monetary policy has grown more credible and inflation expectations have been anchored more firmly at the target. In both instances, the question of how much remains unanswered.

As far as the exchange rate is concerned, conventional measuring methods do not indicate that the real exchange rate is clearly above its equilibrium level. This is supported by the Bank's analysis, to be published next week in *Financial Stability*, which shows that 85% of inflows into the foreign exchange market in 2016 were attributable to the current account surplus and transactions between residents. Capital inflows from non-residents are much less important, and in the latter half of the year, when the króna was appreciating the most, carry trade-related inflows were virtually non-existent. Estimating the equilibrium real exchange rate is very uncertain, however, and as a precaution, the Central Bank has leaned against potential overshooting of the exchange rate by buying large amounts of foreign currency.

In this light, it is difficult to conclude otherwise than that the appreciation of the króna has been largely benign, in that it is based on economic fundamentals and contributes to a better balanced economy. The Central Bank's scenario analysis indicates that if the Bank had used policy instruments to halt the currency appreciation in recent years, economic imbalances would have been much greater and inflation considerably higher.

It has been a long time since the Central Bank of Iceland could fix the exchange rate unilaterally on a day-to-day basis. The exchange rate is determined in the interbank market and reflects underlying supply and demand for foreign currency. But the Bank can affect the exchange rate through interest rate decisions, foreign exchange transactions, and the application of capital flow management measures such as the one currently in place: the special reserve requirements on certain types of capital inflows. The exchange rate would have been much higher if the Bank had not applied these instruments and bought large amounts of foreign currency.

But could the Bank have gone further; for instance, by buying even more foreign currency or by lowering interest rates more than was warranted by economic conditions and the inflation outlook? Certainly it could have done so; it could even have gone as far as to more or less halt the appreciation of the króna. But

then large interest rate cuts would probably have been needed alongside the foreign currency purchases, perhaps even bringing real rates into negative territory, which is ill-suited to an economy with a positive output gap and very strong GDP growth. The reason is that in order to lower interest rates enough to materially increase residents' appetite for investment in foreign securities, an interest rate cut of 0.25 or 0.5 percentage points would not be sufficient because of how wide the interest rate differential currently is. It is not a given, either, that long-term interest rates in the bond market would have followed suit in full, and bond market rates are more important for investments by pension funds and other investors than the Central Bank's short-term rates are. The reason for this would have been that inflation expectations had risen, and if the reduction in short-term interest rates had not been in line with economic developments and prospects, expected short-term interest rates would have increased.

This would not have occurred without severe side effects. In this context, it should be borne in mind that in the long term, central banks can affect inflation and can have a corresponding impact on the nominal exchange rate, but they cannot affect the real exchange rate in the long run. If the real exchange rate rises because of an increase in the equilibrium real exchange rate and the Central Bank halts the rise in the nominal exchange rate, the real exchange rate will ultimately rise in any case, through larger wage increases and inflation.

If the Bank had halted the rise in the exchange rate at all costs, inflation would probably be well above the target already, and it is very unlikely that inflation expectations would be at target. This would also have been inconsistent with the Bank's legally mandated price stability objective. It would also have been quite costly, as the credibility of monetary policy would have been gone and interest rates in the future would need to be higher in order to restore that credibility. If there is the will to impede the rise in the real exchange rate and mitigate the crowding-out effect that tourism has on other sectors, which is certainly needed, but without sacrificing price stability, it must be done with policy instruments that can have a lasting impact on the real exchange rate, such as tighter fiscal policy. In this context, it gives cause for concern that the fiscal stance in terms of the cyclically adjusted primary balance has eased over the past two years and appears likely to do so again this year. It is also possible to address the currency appreciation at its source by applying what some representatives of the tourism sector have appropriately referred to as "access restrictions and pricing".

In the recent past, numerous observers have expressed the opinion that the Central Bank's key interest rate is too high under current conditions. As grounds for their arguments, they cite much lower interest rates in trading partner countries, the fact that inflation in Iceland has been at or below target for three years, and the Central Bank's overforecast of inflation in recent years. Discussing whether the monetary stance is in line with the Bank's objectives and current economic developments and prospects is normal and appropriate. Opinion varies, sometimes even within the Monetary Policy Committee itself, because reliable data on current and recent developments become available with a time lag and the future is always uncertain.

The Bank's key nominal interest rate is now 5%, and the corresponding real rate is about 2½%. In view of the business cycle position and the fact that inflation is below target, this implies an equilibrium real rate of 1½%, which must be considered low, given that long-run growth potential is significantly higher. Current nominal and real interest rates are not high in historical terms, although they are high in current international context. The explanation, however, lies in historically very low interest rates abroad rather than abnormally high rates in Iceland. In many economies around the world, inflation has been below target levels and central banks have overforecast inflation in the recent past, largely irrespective of the level of interest rates and the economic cycle in individual countries. This indicates strongly that there are global factors at work, such as low commodity prices and resistance to wage increases in industrialised countries, partly in response to increased direct and indirect competition from the labour forces of other economies and uncertainty about the future in the wake of the financial crisis.

The current monetary stance is not affected by the Bank's previous overforecasting of inflation. The MPC takes account of forecasts but does not blindly set interest rates in accordance with them, and it adjusts the monetary stance in view of developments. The forecasts themselves are revised each quarter. One to two years ago, forecasts were based both on the technical assumption that the exchange rate would remain unchanged at far below the current level and on expectations of a turnaround in global commodity prices, which international forecasts had assumed would be stronger and come sooner than has actually been the case. These forecasts were accompanied by a future interest rate path that never materialised. It is therefore necessary to assess the monetary stance at any given time on its own merits. The MPC has done this and will continue to do so. Near-term developments in nominal and real interest rate will be determined by economic developments and the inflation outlook. The MPC attempts at all times to keep interest rates no higher than they must be in order to hold inflation at target over the medium term. Based on these considerations and assuming that there are no major unforeseen changes in the current situation, the scope for further reductions in nominal interest rates could develop in the near future.

The Government has initiated a review of the monetary policy framework. The Central Bank of Iceland supports this process and will participate actively in it. It is important both to take into account what monetary policy can achieve and to acknowledge what it cannot do. It is also important to bear in mind that significant changes have already been made in monetary policy conduct since the pre-crisis period, as I have discussed in detail in this setting in the past. Nevertheless, various additional changes need to be considered, and the Central Bank cannot change the most important element of the equation: that monetary policy, fiscal policy, other economic policy, and decisions taken in the labour market must pull together to the maximum extent possible. I would also like to emphasise the importance of preserving the monetary policy achievements that I have discussed.

Honoured guests: The Central Bank's foreign exchange reserves totalled over 810 b.kr. or 7½ billion US dollars, at the end of February. This is equivalent to about one-third of GDP. The reserves were above the minimum aimed at during the prelude to capital account liberalisation. Relative to GDP, Iceland's reserves are currently at their largest since the end of World War II.

There is no doubt that we have already benefited greatly from these relatively large reserves. They have enabled us to lift the capital controls without taking excessive risk with economic and financial stability. The reserves play a key role in Iceland's recent credit rating upgrades, as can be seen in the press releases from the rating agencies. The upgrades will lead to an improvement in the borrowing terms offered to the Treasury, the banks, and large companies in foreign credit markets. And last but not least, large reserves provide a buffer against shocks in the future. They greatly increase the probability that if the króna depreciates because the equilibrium exchange rate has fallen and the positive output gap has closed, it will not pose a threat to stability. Many countries have undergone such an adjustment, and a sudden collapse of the currency such as that occurring in Iceland during the financial crisis is the exception rather than the rule.

The benefits deriving from the reserves are therefore significant. The problem, however, is that the benefits are distributed widely, while the Central Bank bears the costs alone. Last year the Bank recorded an operating loss of 35 b.kr. This was due to an exchange rate loss of nearly 90 b.kr. on the reserves, owing to the appreciation of the króna during the year. However, it is an unrealised accounting loss, and it would reverse if the exchange rate should move in the opposite direction. No assets have been lost. The foreign currency value of the reserves is unchanged, and the purchasing power in terms of what the reserves would be used for is intact.

Other aspects of the matter are of greater concern: the negative interest rate differential resulting from investing the reserves at historically low foreign interest rates and the interest expense on the Central Bank's króna-denominated liabilities, which bear much higher interest. Extrapolations to 2025 indicate that, other things being equal, the Central Bank will record losses of 18 b.kr. per year from 2018 onwards, and the Bank's equity will be negative thereafter. This in and of itself is not Armageddon, and many central banks have functioned quite successfully with negative equity. Nevertheless, it is better for a number of reasons if the Central Bank has an acceptable capital position. Extrapolations carried out by the Bank show that with various measures and appropriate distribution of the cost of the reserves among the parties that benefit from them, the gap can be closed. Among the measures is the possibility of increasing returns on the reserves by splitting them up into two or more tranches based on term and yield.

The question has arisen whether the foreign exchange reserves are too large, or in other words, whether the costs outweigh the benefits. Examining comparable

countries and the risks facing them suggests that this is not clearly the case. Furthermore, we must not forget that foreign exchange reserves can grow rapidly in small countries, as our own history illustrates, but they can also be depleted more rapidly than in large countries when shocks strike. Various small countries with their own currency and independent monetary policy have reserves equal to a third or more of GDP, among them Israel, Peru, Singapore, Switzerland, and the Czech Republic. Iceland is currently in the middle of the one-third of countries with the largest reserves but, with one exception, it has proportionally the least foreign currency reserve assets among the countries that have established a sovereign wealth fund.

Honoured guests: I have spoken at length about monetary policy, the exchange rate, and the foreign exchange reserves, three topics of current interest. I have devoted less time to the financial system, which I discussed in greater depth last year. The Bank's *Financial Stability* report will be published next week, however, and risks in the financial system will be covered thoroughly there. It is no secret that there are growing concerns about the housing market, and it may well be that macroprudential tools will be activated in the near future so as to mitigate the risks attached to it. The Bank's *Financial Market Infrastructure* report will be issued early in June, and much is happening in that arena with the renewal of payment systems and the impact of technological developments on banks and payment intermediation.

Honoured guests: The legacies of the financial crisis have now by and large been dealt with. We are now embarking on a new period of capital account openness. This entails both opportunities and risks. We must seize the opportunities, analyse the risks, and take appropriate action. To the best of its ability, the Central Bank will contribute to this process where appropriate.

In closing, I would like to thank the Supervisory Board and the Monetary Policy Committee for their work over the past year, and I wish to thank the Central Bank's many colleagues and collaborators for their cooperation – not least the Prime Minister's Office, the Ministry of Finance and Economic Affairs, and the Financial Supervisory Authority. I would also like to thank the financial institutions with which the Bank interacts for their cooperation. Furthermore, I would like to thank the Parliament of Iceland, particularly the Economics and Commerce Committee, for their collaboration. And last but certainly not least, I want to thank the staff of the Central Bank for a job well done over the past year.