Ingimundur Friðriksson: Monetary policy and the current monetary situation

Address by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, to a civic club meeting in Reykjavík, 26 February 2003.

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The framework for monetary policy in Iceland was altered decisively in March 2001. The government and the Central Bank issued a joint declaration adopting inflation targeting as the mainstay of monetary policy and abandoning the fixed exchange rate policy which had been followed for just over a decade. To begin with, a relatively narrow target band was set in the previous regime for the reference exchange rate of 2¼% in either direction around the central value for the króna. This was widened in two stages, to end up as a 9% deviation in either direction early in 2000. During this period, price stability was the principal objective of monetary policy and a stable exchange rate was an intermediate target. Since the adoption of inflation targeting, the Central Bank's inflation forecast could be said to have actually served as an intermediate target of monetary policy, with the ultimate objective price stability. Inflation targeting has established itself in many countries in recent years and has formed the backbone of monetary policy, for instance, in the UK, Sweden, Norway and New Zealand, with good results in each case.

In May of 2001 the Icelandic parliament Althingi unanimously adopted a new Central Bank Act, which entailed extensive changes from the previous legislation. Taking into consideration innovations in central bank legislation in other countries, this Act consolidated the new inflation targeting policy. The most significant change from the earlier legislation was to set a single, principal objective for the Central Bank, i.e. to promote price stability. The Bank was also granted the independence to apply its instruments in order to achieve this objective. Furthermore, it was assigned the task of maintaining Iceland's foreign exchange reserve and fostering an efficient and reliable financial system, i.e. financial stability. The Act also stipulated that the treasury may not borrow from the Central Bank. Specific requirements were set out concerning transparency and accountability towards both the government and the public. For example, the Bank is now obliged to publicly account for its monetary policy and for monetary and exchange rate developments and its actions in these areas at least quarterly.

The principal objective of current Central Bank monetary policy, as stated in the joint declaration issued by the Bank and the government in March 2001, is to keep inflation as close as possible to 2½%. Should inflation deviate from this target by more than 1½ percentage points in either direction, the Bank is to provide the government with a written public account explaining what has caused this deviation, how the Bank intends to respond and how long it expects that it will take for inflation to once again return to within the targeted inflation limits.

The Central Bank has only one instrument at its disposal to achieve this objective: interest rates. The significant interest rate here is that used in the Bank's repurchase transactions with credit institutions, sometimes referred to as the Central Bank's policy interest rate. Such transactions in fact represent the Bank's liquidity facility for these institutions. The commercial and savings banks subsequently set their own rates of interest, having regard to the Central Bank's policy rate, and short-term market interest rates generally change in phase with the Central Bank rate. If other factors remain constant, changes in the Central Bank interest rate also affect long-term interest rates, but here other aspects also enter the picture. The response of these rates to changes in the Central Bank rate is therefore not always predictable and tends to occur with a certain time lag.

Inflation forecasting plays a crucial role in Central Bank policy. It produces four forecasts annually, which are published in its quarterly Monetary Bulletin. The inflation forecast extends just over two years into the future, on a quarter-by-quarter basis. As in other countries, interest rate changes by the Central Bank take quite some time to have an impact throughout the economy. This makes it necessary to have a forward-looking policy, with the inflation forecast based on state-of-the-art methodologies. In addition to its inflation forecast, the Central Bank publishes a quarterly assessment of the economic and monetary situation and prospects, including a national economic forecast, and their probable impact on price level developments. If inflation looks likely to exceed the Bank's target limits in a long-term perspective, the Bank will raise its policy interest rate, or cut this rate if inflation is heading below the target limit.

In preparing its inflation forecasts and regular assessment of the economic situation and outlook, the Central Bank examines a wide variety of indicators. These include both statistical data and information obtained from interviews with representatives of industry, special interest groups, credit institutions and others. Much of this statistical data is available on the Bank's website.

Decisions by the Central Bank's Board of Governors are made following in-depth examination of these indicators, based on the Bank's evaluation of the situation and prospects, the premises behind the inflation forecast and the inflation forecast itself. In accordance with the provisions of the Act which entered into force in the spring of 2001, the Board adopted internal rules on the preparation of, arguments for and presentation of its monetary policy decisions. The rules were formally approved at the beginning of 2002 and published in the quarterly Monetary Bulletin.

The inflation target adopted in March 2001 removed the earlier fluctuation bands set for the ISK exchange rate and the exchange rate was floated. The new monetary policy framework was introduced under rather difficult conditions, with a sliding exchange rate and mounting inflation. It is fair to say that the tight monetary stance is the main reason that inflation receded as sharply as it did in 2002. Experience has shown that the monetary policy passed this demanding trial with flying colours and no one should any longer doubt its value for the Icelandic economy. It works in Iceland just as it does everywhere else.

The Central Bank responded to imminent inflationary pressure by raising its interest rates in 1998 and still further in 1999 and 2000. The interest rate increase served to reduce excess demand in the economy and the ISK exchange rate rose, thus slowing increases to the consumer price index (CPI) in an overheated economy. Early in 2000 the fluctuation bands for the króna were widened, in part because the previous limits were then felt to be restraining the rising exchange rate, which was regarded as necessary to counter inflationary pressure. The exchange rate peaked in the spring of 2000, when it was just over 12% higher than at present.

Market expectations changed in the spring of 2000, and the exchange rate began a downward trend. There are no doubt various explanations as to why this occurred but probably the major factors were concern at a sizeable current account deficit and the resulting enormous need for foreign financing, together with Icelandic investments in foreign securities during that same year, not least by pension funds. The downward exchange rate slide lasted until late November 2001.

Several times during the period from mid-2000 until well into 2001, the Central Bank intervened in the currency market in an attempt to prevent a further decrease in the exchange rate. The Bank intervened in particular when a downward spiral seemed to be forming, or when the Bank felt that its intervention could have a positive effect in changing market expectations. This was based in part on the Bank's conclusion that the exchange rate had already dropped more than was reconcilable with long-term equilibrium in the economy. The Central Bank expended substantial sums in intervening on the foreign exchange market, over ISK 40 billion in total, without this sufficing to halt the slide of the króna. At best, it may have slowed the depreciation until the economy had cooled somewhat, and it also contributed to making the inflationary impact of the exchange rate drop less than it would otherwise have been.

An article by Gerður Ísberg and Þórarinn G. Pétursson in this February's issue of the Central Bank's Monetary Bulletin describes the Bank's actions on the foreign exchange market during 2000 and 2001 and assesses their impact. The article concludes definitively that at best the intervention had only short-term effect in each case and the market soon returned to its previous situation. In other words, their conclusion is that intervention on the foreign exchange market against strong prevailing currents has precious little effect unless accompanied by corresponding changes in the domestic interest rates. This is in full accord with the experience in other countries.

In recent public discussion the claim has often been made that the exchange rate of the króna is far too high and that the Central Bank needs to take steps to bring it down again. The fact of the matter is that the Bank's means of controlling the exchange rate are overestimated and the power of the market underestimated when the claim is made that the Central Bank can, through its actions, direct the króna to a specific level. The proposal has been made, for instance, that the Central Bank cut its interest rates substantially with the aim of lowering the exchange rate. In this context it should be pointed out that the Bank has cut its policy rate substantially, from 10.4% only a year ago (11.4% two years ago) to 5.3% at present. The Bank's nominal policy rate has not been lower since 1994 and the real policy rate is at its lowest since 1996. The domestic and foreign interest rate differential has narrowed significantly. In addition, the Central Bank's interest rate is now below the estimated equilibrium interest rate and thus has a stimulating effect on the economy. The impact of interest rate changes generally is only visible after a certain time lag, prompting one to conclude that the effect of the major decrease in interest rates during the past year has yet to be fully felt.

As is well known, the exchange rate for the króna plummeted in 2000 and 2001, and for quite some time was substantially below a level reconcilable with long-term equilibrium. This occurred at a time when the price of key exports was very high, making the years 2000 and 2001 especially favourable for the export sector and in fact also for import competing sectors. Enterprises in these sectors now understandably feel the effects of the rise in the exchange rate. It is not to be expected, however, that the same conditions will again arise in these sectors as prevailed, for example, during 2001 and in the early part of 2002. In this connection it could be mentioned that, based on the predictions on performance made by financial enterprises, the contribution margin in fisheries companies will be fairly good this year, although not as good as in 2001 and 2002, which were quite exceptional.

In the February issue of its Monetary Bulletin, the Central Bank published an analysis of the proposed major construction projects in East Iceland[1] and possible responses for economic management. The article concludes that unless economic counter-measures are taken, the projects will create overheating in the economy, inflation and instability. Although their scope will be considerable, the projects are not so large that economic stability cannot be preserved and inflation contained by means of appropriate responses in economic management. Mitigating measures would be most effective if they involved both monetary and fiscal restraint, as well as internal adjustment of the national economy, including a rise in the exchange rate. The more restraint shown on the fiscal side, the less need there will be to raise interest rates. A higher króna exchange rate also means less cause to raise interest rates.

The exchange rate was fairly stable from the spring of 2002 until early this winter. It then began to rise and continued to do so steadily until early February of this year. The Central Bank has stated its view that the exchange rate rise in recent months has been primarily due to the effect of the proposed major construction projects in East Iceland. The operations of the aluminium smelter will likely cause the equilibrium exchange rate for the króna to be higher than otherwise. Furthermore, it appears evident that the influx of foreign currency in connection with these projects will be considerable, with higher domestic interest rates than otherwise. All of this affects market expectations and makes the króna exchange rate higher than it would be in the absence of plans for major development in East Iceland. The economy could thus be said to have already begun adaptation to the coming projects, i.e. the exchange rate adjustment has begun and is even well on its way.

In view of what has already been said, it is clear that industry and business in Iceland has to prepare itself for a higher exchange rate than would have been the case without this major development. It naturally demands careful management and cost-cutting in operations where required.

As mentioned previously, the Central Bank of Iceland now practices inflation targeting intended to keep inflation as close as possible to 2½% per year. The Bank's latest forecast predicts that inflation will be slightly below this mark during the next two years, or just over 2%. Following this forecast, the Bank cut its policy rate by 0.5 percentage points.. All other things being equal, this will mean that inflation will be slightly higher than that assumed in the forecast. Were interest rates to be lowered significantly from the current level, it would very likely set off a new wave of inflation and instability, which would be to the advantage of neither wage earners nor industry.

As mentioned, there seems to be some overestimation of the possibility of the Central Bank to control the market rate of exchange. But, as was also pointed out, the Bank's intervention on the foreign exchange market, expending large sums in 2000 and 2001, had only a short-lived effect. In this connection, it should also be noted that since last autumn the Central Bank has regularly purchased foreign currency in the domestic interbank market. When this decision was announced, it was stated that the Bank intended to purchase the equivalent of ISK 20 billion of currency by the end of 2003. To start with the Bank purchased USD 1.5 million on Mondays and Wednesdays each week. This January the Bank also began to purchase this same amount on Fridays as well, and in February purchases were added on Tuesdays and Thursdays. Currently the Bank thus purchases USD 7.5 million each week, or the equivalent of USD 390 million on a yearly basis. Even though the impact of these purchases on the exchange rate will likely be slight in the long term, as is generally the case with such intervention on the foreign exchange market, the króna rate will be somewhat lower for a while than would have otherwise been the case.

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[1] Aluminium smelter and related power plants.

As was previously pointed out, the Central Bank spent the equivalent of ISK 40 billion to try and shore up the falling króna in the years 2000 and 2001. As a result, the Bank's net external position worsened significantly and since that time its currency reserves have to a considerable extent been maintained with foreign short-term loans. The Bank's plans to purchase the equivalent of ISK 20 billion in foreign currency, announced last autumn, involved paying off at least a major portion of short-term debt. This was also the primary purpose of the purchases.

The decision on foreign currency purchasing was taken under completely different conditions than existed later in the winter when the major development projects in East Iceland changed from plans to reality. The Central Bank's foreign currency reserves are currently ISK 36 billion (USD 460 million) and it could be argued that they need to be considerably greater. Considering the new circumstances and the altered outlook due to the expected major development and resulting influx of foreign currency, barring unexpected changes the Central Bank will very likely continue its regular purchases of foreign currency on the domestic interbank market even after reaching the ISK 20 billion point. By so doing the Bank would avail itself of the opportunity to boost its foreign currency reserves beyond that which would otherwise be practical.

Public discussion in recent weeks has been characterised by considerable criticism of the Central Bank and its monetary policy. From the Bank's point of view, the debate seems a bit peculiar in some respects, not least because views have typically been attributed to it which have no basis in the writings, speeches or other statements issued by the Bank or its executives. As has been pointed out, people also seem to overrate the ability of the Central Bank to direct market developments, as well as to expect it to strive to achieve all sorts of objectives which it has practically no possibility of accomplishing, and which are in fact not part of its role, such as ensuring a certain exchange rate, full employment, etc. After the introduction of inflation targeting in 2001, the Central Bank has no specific objective as far as the exchange rate is concerned. This is in accordance with its policy of targeting inflation and a floating exchange rate. This has been interpreted to mean that the Bank is completely disinterested in developments in the exchange rate. This is not true. The exchange rate for the króna is very important, the events of the past year or two are more than sufficient indication of that. As the Bank has previously pointed out, the real exchange rate at present is not far from average over the past 20 years, nor much above the average of the past 10 years. The nominal exchange rate since the beginning of this year is in fact slightly lower than it was during the same months two years ago. The exchange rate for the króna is determined by the situation and strength of the national economy, external equilibrium and market expectations. The present exchange rate thus reflects to a considerable extent factors which the Central Bank can do little to influence.

The large exchange rate fluctuation from 2000 to 2002 can be attributed to specific circumstances, and the exchange rate is unlikely to fluctuate as substantially in the immediate future as it did during this period. It should be borne in mind, however, that the nature of the Icelandic economy and its small size does mean that currency fluctuations as a rule will be greater than between the currencies of larger economies. In this connection, however, it can also be pointed out that the Euro lost more than one-quarter of its value against the US dollar from the beginning of 1999 until it bottomed out, and since that time has risen once more by just over one-fifth.

The Central Bank is not unconcerned about the exchange rate, but has limited means of influencing its development, as has been explained. There is only so much the Bank can do to restrain currency fluctuations. A substantial lowering of interest rates could possibly force the exchange rate down somewhat, but this would mean sacrificing other and more important objectives for precious little gain. The joint declaration issued by the government and the Central Bank in March of 2001 states that the Bank will intervene in developments on the foreign exchange market through buying and selling foreign currency if it deems this to be necessary in order to achieve its inflation target, or if it is concerned that exchange rate fluctuations could threaten financial stability. There is no cause for so doing at present.

As I mentioned, the primary objective of the Central Bank's monetary policy is to foster price stability. Price stability is recognised to be a prerequisite for long-term economic growth and thus improved welfare. The Central Bank has lightened its monetary restraint substantially in recent months. In the course of ten months, the policy rate has been cut very significantly, resulting in a real policy rate which is lower now than it has been since 1996, as I mentioned. At the same time, the Bank has also given notice that further relaxation is envisaged in the form of lower required reserves by the Central Bank. The impact of the recent interest rate cuts has yet to be fully reflected in the economy. Although claims are frequently advanced that the real exchange rate for the króna is currently too high, the Central Bank cannot influence the real exchange rate except for a limited time. Too much relaxation of monetary policy at present would only prepare the ground for the next period of over-expansion and inflation, with accordant instability.

As mentioned, the Central Bank announced an interest rate cut of 0.5 percentage points earlier this month and plans to relax reserve requirements. The announcement of the Bank's decision also pointed out that there were opposing arguments as to whether and to what extent further relaxation of monetary restraint would be implemented. Following the announcement of the interest rate cut, the government announced its plans to allocate funding to various construction projects to support employment, with several local authorities following suit. Furthermore, it now appears likely that work will get underway this year on an enlargement to the Norðurál aluminium smelter and power developments linked to it. These factors will naturally be taken into consideration in decisions on monetary policy in the weeks and months to come.

As I mentioned at the beginning, the framework of monetary policy was changed in 2001 with the introduction of inflation targeting. This is in line with international developments in recent years, resulting in Central Banks being entrusted with a single main objective, i.e. to promote price stability. Price stability was set as the primary objective of monetary policy because inflation is above all a monetary phenomenon. There is little point in setting objectives for monetary policy which it cannot achieve. Applying monetary policy to achieve price stability also contributes to economic stability. This, in turn, is a prerequisite for future growth in the economy and making the most efficient use of its scarce resources. Other public authorities, industry and interest groups also need to adapt their decisions to accord with this inflation targeting.