Már Guðmundsson: Monetary policy at a crossroads

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the Icelandic Chamber of Commerce Monetary Policy meeting, Reykjavík, 5 November 2015.

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Honoured chairman, ladies and gentlemen:

The Iceland Chamber of Commerce has a decades-long 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.

The title of my talk today is *Monetary policy at a crossroads.* These crossroads are, first, the disappearance of the slack in the economy and the development of a positive output gap, with the result that the task of monetary policy is no longer to stimulate GDP growth to the extent that the inflation target allows but to ensure that the tension in the economy does not cause overheating, which would jeopardise economic stability. The second crossroads is that, in recent months, the labour market situation has become much more serious than would have been anticipated given the state of the economy. The third lies in the unusual level of uncertainty about the inflation outlook, stemming from the interplay between domestic inflationary pressures and the global tendency towards deflation. And fourth is the recent rapid progress in solving the of the balance of payments problem Iceland has faced since the financial crisis struck and the approaching liberalisation of capital controls. Because of this, the monetary policy transmission mechanism has been somewhat disturbed, as Iceland is more susceptible to contagion from low global interest rates at a time when financial conditions and the banks' liquidity are changing.

Some might say that these represent challenges rather than a crossroads. I prefer crossroads as a metaphor, however, because in all of these instances the economy is moving from one state to another. This certainly poses challenges for monetary policy and for all economic policy. But they are compounded by the fact that the economy is travelling through all of these crossroads at roughly the same time, and the challenges often interact in a manner that makes monetary policy formulation and conduct more problematic than usual. This will become clearer after I have described each of the crossroads more fully.

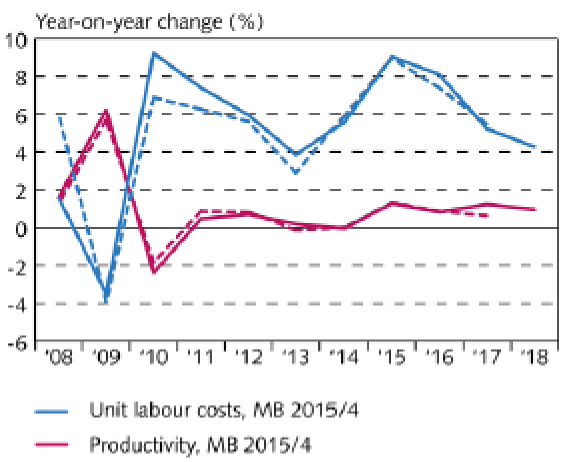
The first one is growing demand pressures in the domestic economy. According to the Bank's forecast, published yesterday, GDP growth in 2015 and 2016, measuring 4.6% and 3.2%, respectively, will exceed growth in potential output. The sizeable slack that developed during the economic contraction ending in 2010 was gradually absorbed between 2011 and 2013. Measured productivity growth has been negligible or non-existent and GDP growth therefore labour-intensive. As a result, unemployment has declined rapidly and demand pressures have developed in the labour market. According to the forecast published yesterday, the positive output gap is expected to peak next year at 1½% of GDP. Domestic demand will grow well in excess of GDP during the forecast horizon, which extends into 2018. Terms of trade are projected to improve significantly this year, contributing to a larger current account surplus than would otherwise occur, but the improvement will reverse to an extent in 2017 and 2018. The sizeable current account surplus of the past few years will therefore shrink significantly during the forecast horizon and will have nearly disappeared by 2018.

Rapid growth in domestic demand under conditions of full utilisation of resources has often proven dangerous to Icelanders. Other things being equal, such a situation calls for monetary and fiscal tightening. Our initial position is unusually good this time, as can be seen in a strong current account surplus, a central government surplus and declining government debt, and inflation that is still below the target. But the tug-of-war between large pay increases and the global tendency towards deflation will determine how much and how rapidly this situation deteriorates in the coming term.

In my speech at the Central Bank's Annual General Meeting, I expressed considerable concern about the unrest in the labour market and the consequences that it could have for economic stability. In the speech, I noted that wage pressures that jeopardise the inflation target are generally considered a sign of both demand pressures in the economy and excess demand in the labour market, which must be met with tighter monetary policy. However, this was not consistent with a slack that was just about to disappear and a sizeable current account surplus. I mentioned another possible explanation: that the consensus on wage differentials had broken down at the same time that the opening of the labour market vis-à-vis abroad put pressure on those differentials – in some cases, in the direction opposite to that demanded by labour market organisations. This is consistent with theories indicating that, other things being equal, if there is a broader consensus about income distribution, a lower level of unemployment will be consistent with low and stable inflation.

Other possible explanations should be borne in mind, however, in any interpretation of developments in the labour market. One is that the recent improvement in terms of trade has created greater scope for non-inflationary wage increases. This is true, to the extent that the improvement is not merely transitory. But even if it is merely transitory, it keeps inflation from rising above target for a while, even if wage increases are well in excess of the level that is consistent with the target in the long run. Another possible explanation is that the equilibrium real exchange rate is rising at present because of the improvement in terms of trade and the reduction of external debt, owing in part to the settlement of the failed banks' estates and the release and tying-up of offshore krónur. To the extent that this does not surface in a nominal currency appreciation, it will put temporary pressure on wages and prices.

Unit labour costs and productivity 2008-2018[1]



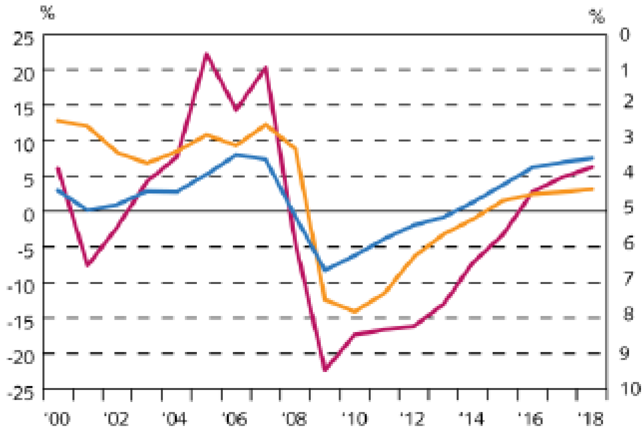
1. Productivity measured as the ratio of GDP to total hours worked. Central Bank baseline forecast 2015-2018. Broken lines show forecast from MB 2015/3.

Sources: Statistics Iceland, Central Bank of Iceland.

It seems to me that a number of signs indicate that all of these explanations apply to some degree. But the consequences for economic stability will be determined, among other things, by the weight of each one and by the response of monetary policy and other economic policies. In any case, it is clear that something has to give. As Chart 1 shows, we are undergoing a period of several years during which unit labour costs are growing well in excess of the level that is consistent with the inflation target. At the same time, productivity growth is very weak.

If the Central Bank's most recent forecast materialises, the result will be as is shown in Chart 2: the real exchange rate and wage share will rise far above their historical averages, and the tension in the labour market will be amplified even further.

Real exchange rate, wage share, and unemployment[1]



Wage share, % of gross factor income (deviation from 20-yr average, left)

Real exchange rate (relative prices), deviation from 1990-2014 average (left)

Unemployment (inverted right axis)

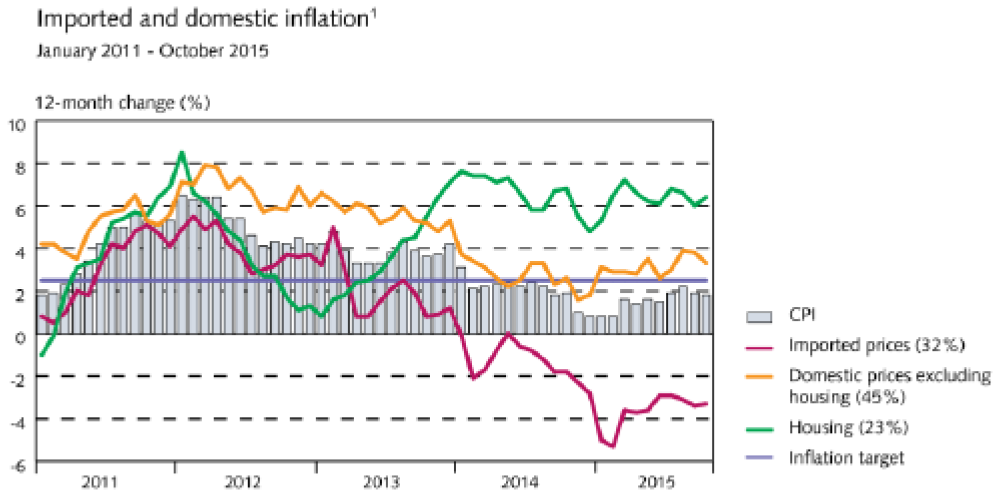
1. Central Bank baseline forecast 2015-2018.

Sources: OECD, Statistics Iceland, Central Bank of Iceland.

But I consider it unlikely that this will be the outcome. Either the adjustment will take place through some combination of higher inflation and higher unemployment, or positive shocks will provide some assistance; for example, the improvement in terms of trade will be greater and more lasting, productivity growth will be stronger, and interest payments to abroad will be lower because of reduced external debt and improved credit ratings. It will be very interesting to see how things develop in the next few years. It would be imprudent, however, for economic policy and contingency planning to rely blindly on positive shocks.

And then there is inflation. Inflation has risen more slowly following the recent pay hikes than perhaps could have been expected in view of historical experience, and it is still well below target. This could be due in part to the additional scope provided by the favourable initial position of many firms and by the improvement in terms of trade. But the most obvious explanation is that lower prices in international trade and low or zero inflation in trading partner countries offsets domestic inflationary pressures, as can be seen in Chart 3.

The downward price pressures from abroad have been stronger in recent months than was projected last spring, partly because of economic developments in China. But it is unlikely that the price of oil and other commodities will continue falling for a long time to come. The question, then, is what happens when prices stop falling – not to mention if they begin to rise again, as is forecast. Other things being equal, measured inflation would rise in Iceland. The Central Bank's new forecast assumes, in fact, that oil prices will begin to rise again towards the end of this year. In addition, a portion of the wage increases will finally pass through to prices. According to the forecast, inflation will therefore rise in coming months, overtaking the target next year and peaking at just over 4% in the first half of 2017. It will not return to target until 2018. It should be borne in mind that this forecast entails an endogenous tightening of the monetary stance as the positive output gap widens and inflation rises. The Monetary Policy Committee's decision to raise Central Bank interest rates by 0.25% must be viewed in this light.



1. Imported inflation is estimated using imported food and beverages and the price of new motor vehicles and spare parts, petrol, and other imported goods. Domestic inflation is estimated using the price of domestic goods and the price of private and public services. The figures in parentheses show the current weight of these items in the CPI.
Sources: Statistics Iceland, Central Bank of Iceland.

The final crossroads is the most important: the resolution of the balance of payments problem and the liberalisation of the capital controls. It has long been clear that taking this step would entail numerous challenges for monetary policy. Two in particular have been focused on.

The first is that the banks' liquidity position could deteriorate as a result of the liberalisation of the capital controls. The Central Bank has mapped out the potential scope of these effects, as was presented when the settlement of the estates on the basis of stability conditions was announced recently. The result is that the change in liquidity will be within manageable limits. This does not change the fact that the banks must proceed with caution in coming months and protect their liquidity position throughout the process. In support of this, the Central Bank recently increased minimum reserve requirements. The intention is to reverse the change in reserve requirements when the strain on liquidity is at its peak.

The latter is that before capital controls on residents are finally lifted, we must implement a monetary policy framework different from that pursued before the crisis. This is because experience has shown that it is difficult for small economies to pursue independent monetary policy if interest rates are their only policy instrument, their currencies float freely, there are no restrictions in residents' unhedged foreign exchange risk, and financial integration with the rest of the world disconnects the transmission of monetary policy through the interest rate channel.

I would like to pause here, as this last item is of particular importance for Iceland at present. I conducted a study of this topic during my tenure with the Bank for International Settlements in 2004–2009.[1] I delved into it again last summer, as can be seen in the speech I gave in Singapore last August, which can be found on the websites of the Bank for International Settlements and the Central Bank, and in my forthcoming paper, to be published in the

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[1] "Financial globalisation: key trends and implications for the transmissions mechanism of monetary policy". BIS Papers No. 39, April 2008. http://www.bis.org/publ/bppdf/bispap39c.pdf

Singapore Economic Review. These writings contain more detailed explanations, but if we consider the main points and allow the tendencies entailed in financial integration to develop to their limit, the outcome is abundantly clear. The interest rate channel of monetary policy becomes utterly clogged up in small, open, and financially integrated economies where longer-term interest rates are determined by rates in large economies. Monetary policy transmission shifts entirely to the exchange rate channel. But transmission through the exchange rate channel is uncertain and volatile, as the exchange rate is also an asset price that fluctuates with speculative capital flows and can deviate from equilibrium over time, only to correct quite suddenly. Unless the financial system is even better protected, this process can interact very badly with financial stability, as was the case in Iceland during the financial crisis.

In its publications "Monetary policy in Iceland after capital controls" and "Prudential rules following capital controls",[2] the Central Bank has described the framework that it considers appropriate to replace the pre-crisis framework. Much of what is described in the two reports has already been put in place, but the final brushstrokes remain undone. We intervene in the foreign exchange market; i.e., we have a managed float and not a free-floating currency. We have adopted prudential rules that greatly reduce the banks' opportunities to take risks with their foreign currency balance sheets. We have established a Financial Stability Council and a Systemic Risk Committee in order to monitor financial system risk more effectively than we did previously, and we are developing prudential rules and macroprudential tools to respond to systemic risk. This will make the conduct of monetary policy easier. And in addition, I hope that statutory amendments will be passed soon in order to put brakes on foreign-denominated lending to resident borrowers without foreign currency income and assets.

But the final brushstrokes remain undone: we have yet to develop tools that can be used to reactivate the interest rate channel if and when it becomes clogged up because of capital inflows related to carry trade. In this context, one might ask whether we are too late. To be sure, the capital inflows are taking place sooner than generally expected. We still have not released those who entered last, but we have already received capital inflows of nearly 50 b.kr. for investment in nominal Treasury bonds – most of it after Iceland's sovereign ratings were upgraded because the next steps towards capital account liberalisation were announced in early June! And this has certainly disrupted the monetary policy transmission mechanism, as can be seen in Chart 4.

Thus far, the impact has been more or less limited to the Treasury bond market, and the banks' nominal interest rates have broadly followed Central Bank rates. The first signs of contagion to other parts of the financial market had begun to show before the Central Bank's rate hike yesterday. It will be interesting to see what impact the rate hike has.

Independent monetary policy entails the possibility of maintaining a different monetary stance than other countries do if and when the need arises. Recent research and international discourse indicate that it can be difficult for small, open, and financially integrated economies to pursue monetary policy that differs significantly from that in large economies. The final brushstrokes entail developing tools that will, if applied, restrict the benefits accruing to non-residents as a result of our having higher interest rates than our trading partners. The precise structure of this will come clear in the next few months, but possibilities include some form of taxation or a special reserve requirement.

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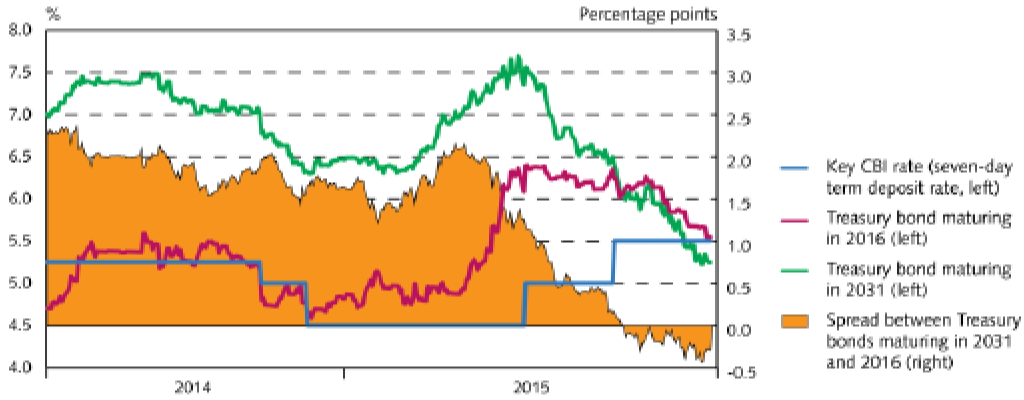
2 Central Bank of Iceland *Special Publication* no. 4: *Monetary policy after capital controls,* December 2010 and Central Bank of Iceland *Special Publication* no. 6: *Prudential rules following capital controls,* August 2012. http://www.cb.is/publications/publications/special-publications/

Key Central Bank rate and nominal Treasury bond yields

Daily data 21 May 2014 - 30 October 2015



Source: Central Bank of Iceland.

I have now reviewed the multiple crossroads that I mentioned at the outset. Each one of them poses a challenge for monetary policy. But it is not least the interactions among them and the timing that make monetary policy so unusually complicated at present. For instance, it would be much easier to cope with capital inflows if domestic economic developments did not call for a tighter monetary stance at this juncture. The oft-quoted Chinese blessing – or curse – “May you live in interesting times” – continues to follow us.

Thank you.