14 March 2018

Governor's statement on the special reserve requirement on capital inflows, delivered at the press conference on the Bank's interest rate decision

In Monetary Bulletin 2017/4 (Box 2), published last November, the Bank stated that the special reserve requirement (SRR) on capital inflows would remain unchanged for the time being, as the interest rate differential with abroad was still sizeable. The Bank also noted that the SRR would be lowered as soon as conditions warrant it and that the general aim would be to keep it inactive whenever possible. This position has not changed, as little time has passed since then and the interest rate differential is broadly unchanged since November.

In the recent past, this position has been criticised, as have the design and implementation of the SRR. The Central Bank considers it appropriate to review this criticism so as to determine to what extent it is justified and, where it is justified, to examine possible remedies. The criticism lodged has been primarily of two kinds. First, it is asserted that the SRR has promoted higher interest rates and that diminishing demand pressures give cause to stimulate foreign investment rather than the reverse. In this context, it is even argued that the Bank's most recent interest rate reductions have not been transmitted to interest rates for households and businesses. Second, there has been criticism of the technical implementation of the SRR, the asset classes affected by it, and the potential adverse impact on the effectiveness of individual markets.

The argument that the SRR has led to higher interest rates in Iceland is not well grounded. The declared objective of the SRR was to shift monetary policy transmission more to the interest rate channel rather than to the exchange rate channel. So, in essence, critics are using the same argument against the SRR as was used in favour of its adoption! Without the SRR, interest rates in Iceland would probably be lower than they are at the moment, but the exchange rate of the króna would be higher, as monetary policy transmission would have been stronger through the exchange rate channel. The Bank's assessment is that, under current circumstances, this would be an unfortunate mix, as the real exchange rate is currently very high in historical context, and a further rise would bring with it increased risk and strain on export sectors. To be sure, these effects would probably be temporary, as both economic theory and empirical research indicate that capital flow management tools of this type do not have a long-term effect on the real exchange rate any more than monetary policy in general does. But under current conditions, even a temporary rise in the real exchange

rate could do damage for quite some time and could exacerbate the risk of exchange rate instability further ahead.

With reference to the argument that current conditions warrant stimulative measures, it should be noted that although the positive output gap has begun to narrow, it remains sizeable, and there is no cause as yet to take steps to boost demand through foreign investment or by other means. Thus this is not a valid argument for easing the SRR at the present time. Such conditions could develop in the future, however.

At the Monetary Policy Committee (MPC) meeting held this week, the MPC reviewed detailed data on developments in interest rates on various loan forms available to households and businesses. The MPC also examined developments in bond market yields. The data do not back up the argument that Central Bank rate cuts have not been transmitted to other interest rates because of the SRR. Quite the contrary: transmission to lending rates and Treasury bond rates has been normal (see slide). This should come as no surprise because it is generally acknowledged that monetary policy transmission along the interest rate channel becomes stronger when tools such as the SRR are used. In this context, however, reference has been made to the rise in the interest premium on corporate bonds (i.e., the ratio of corporate bond rates to Government bond rates). It is difficult to see how this is caused by the SRR, however, as the imposition of a special reserve requirement on capital inflows should not change the relative rates on the bonds affected by it, particularly if inflows were not previously attracted to the bonds whose prices are falling. Perhaps other explanations are more apt here, such as increased counterparty risk, which manifests itself in falling share prices for the companies issuing the bonds and, in the case of real estate firms, the prospect of smaller rises in property prices. Furthermore, the pension funds could be reducing demand for these bonds, in part by stepping up foreign investment. Finally, it is worth noting that the bonds in question are indexed and have relatively limited turnover, and Central Bank interest rates always have less impact on indexed rates than on nominal rates and the SRR is irrelevant in that connection.

Other criticisms of the SRR pertain to technical design and to the asset classes affected by the requirement. The Central Bank considers it appropriate to review this and has begun to do so. The SRR's boundaries were determined based on the effect intended, but issues pertaining to circumvention were also considered. This is the main reason the commitment period was set at only one year: in order to affect short-term investments, which were more likely to be undertaken for pure carry trade motives.

The Bank has examined these issues and will do so in greater depth in the near future, in connection with its work on setting policy for the future design of the SRR and the ongoing review of its implementation. The main reason for the review is the need to have the SRR available if conditions should warrant its application after the remaining capital controls have been lifted in full. Proposals are being prepared and could be implemented in the final months of this year; however, Parliament will have the last word on the matter. That could prove to be a good time to make further modifications to the SRR.

The main results of this work to date were presented at the MPC's last meeting, where other matters pertaining to the SRR were also discussed. By law, modifications to the SRR are made by the Central Bank, subject to the approval of the Minister of Finance and Economic Affairs. However, the Bank has considered it appropriate, in view of the close relationship between the SRR and monetary policy transmission, that modifications in the SRR be made only after consultation with the MPC.

In sum, the Bank is of the view that conditions do not yet warrant easing the special reserve requirement. However, conditions conducive to easing the SRR will develop in the coming term if forecasts materialise and foreign market conditions change in line with current expectations; perhaps those conditions will develop even sooner if Iceland's positive output gap narrows more quickly, and particularly if it closes and a slack develops. The Central Bank and the MPC monitor these conditions and will recommend responses as appropriate. In general, it can be said that the conditions in favour of easing the SRR will improve as the interest rate differential narrows, the exchange rate falls somewhat, and demand pressures subside.