



Monetary policy: achievements and challenges

*Már Guðmundsson, Governor of the Central Bank of Iceland.
Monetary policy meeting of the Iceland Chamber of Commerce,
held at Gamla Bíó in Reykjavík on 16 November 2017*

Madame Chairman, honoured guests,

Once again, we gather here at the Iceland Chamber of Commerce's monetary policy meeting, which for years has been held after the Central Bank has published its autumn forecast and, in latter years, the Monetary Policy Committee's interest rate decision. I would like to thank the Chamber of Commerce for continuing this tradition and for giving me the opportunity to talk to you about monetary policy.

In my speech at this same meeting last year, I noted that the Icelandic economy had seldom been stronger, as we were experiencing the combined effects of robust GDP growth, full employment, large rises in real wages, below-target inflation, a current account surplus, a strong international investment position, and lower private sector debt than had been seen in years. At that time, we had also achieved a historical milestone in bringing inflation expectations back to target by most measures. The outlook was positive as well, with the prospect of continued strong GDP growth, a current account surplus, and target-level inflation throughout the forecast horizon.

But there were concerns, too: the potential for overheating, the possible over-valuation of the króna, and the uncertainty about what would happen after the general liberalisation of the capital controls.

Now, one year later, the economy is still very strong, yet some important changes have taken place – changes that in some respects have reduced the potential risks to price stability and financial stability.

First of all, the vast majority of the capital controls have been lifted, and these risks have not materialised. Short-term exchange rate volatility did indeed increase, but this was expected, and it was not pronounced enough to cause financial instability, as I will discuss further in a moment. And exchange rate volatility has subsided this autumn.

Second, the historical achievement of monetary policy, which was on the horizon last year, has now been confirmed much more convincingly. The credibility of monetary policy has increased, as can be seen perhaps most clearly in inflation expectations, which are now much more firmly anchored to

the target. It is not least this that made it possible to lower the Bank's key interest rate by a full percentage point in this one year, even though demand pressures in the economy were growing until recently and interest rates were already low in historical context in 2016, after adjusting for the business cycle position. I explained this in detail in my speech last year.

Third, GDP growth appears to be approaching its long-term trend rate more rapidly than previously anticipated, and indications that the positive output gap has already peaked have grown stronger. As a result, the likelihood of overheating has receded, although economic policy mistakes and decisions made in the labour market could certainly increase that likelihood once again.

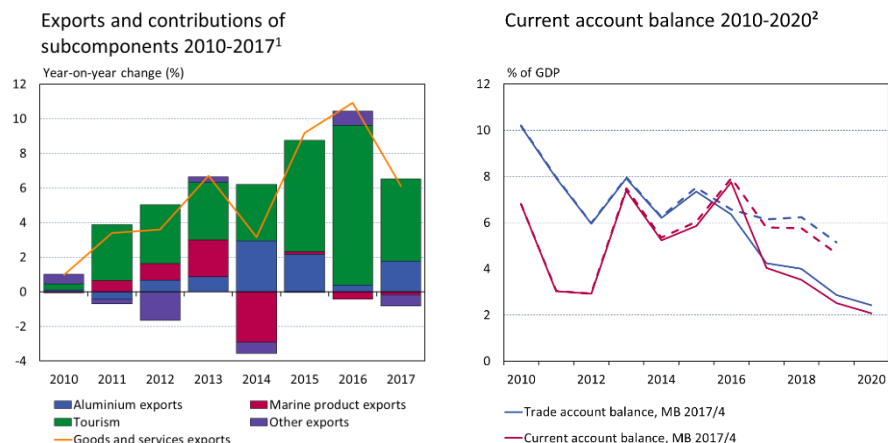
As was the case in 2016, the economic outlook is positive, according to the Central Bank's baseline forecast, published yesterday. GDP growth will slow over the next three years, but this is both desirable and inevitable. The current account surplus will be smaller than previous forecast, but a surplus will remain. There will be full employment, and real wages will rise more over the entire period than can be expected in the long run. Inflation will converge with the target in mid-2018 and remain close to target for the rest of the forecast horizon. This is one of the best inflation forecasts I have seen in my entire career. But it is a baseline forecast, and unforeseen external shocks, economic policy, and decisions made in the labour market could easily change the situation significantly.

Current situation and outlook

Let us now take a closer look at several aspects of the current economic situation and outlook.

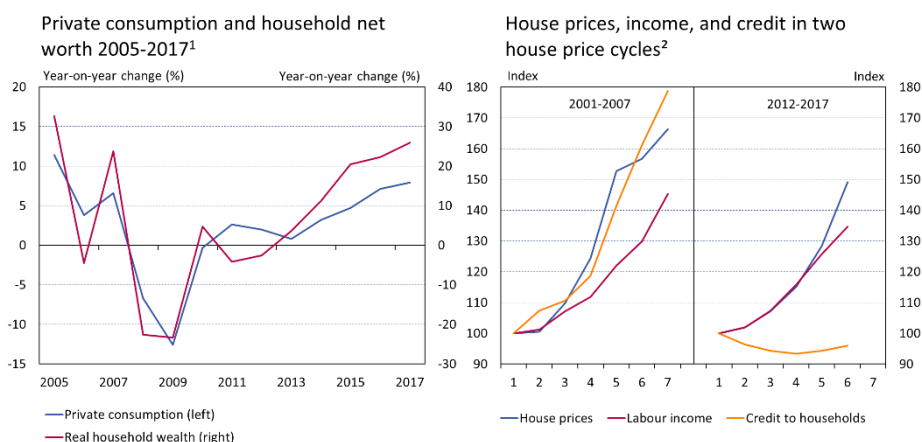
Chart 1 shows how export growth has slowed this year from its 2016 peak yet remains robust. The combination of weaker export growth and increased imports explains the year-on-year slowdown in GDP growth. It also explains the narrower current account surplus, although a deterioration in terms of trade is also a factor. The current account surplus is projected at 2% of GDP by the end of the forecast horizon and could easily be eroded by a surge in demand and/or lower export revenues.

Chart 1



As Chart 2 shows, both private consumption growth and rising house prices are due mainly to increased real incomes and households' improved financial position. This differs greatly from the situation in pre-crisis Iceland, where increased household leverage played a leading role, but as can be seen in the chart on the right, lending to households has not increased in real terms since 2012.

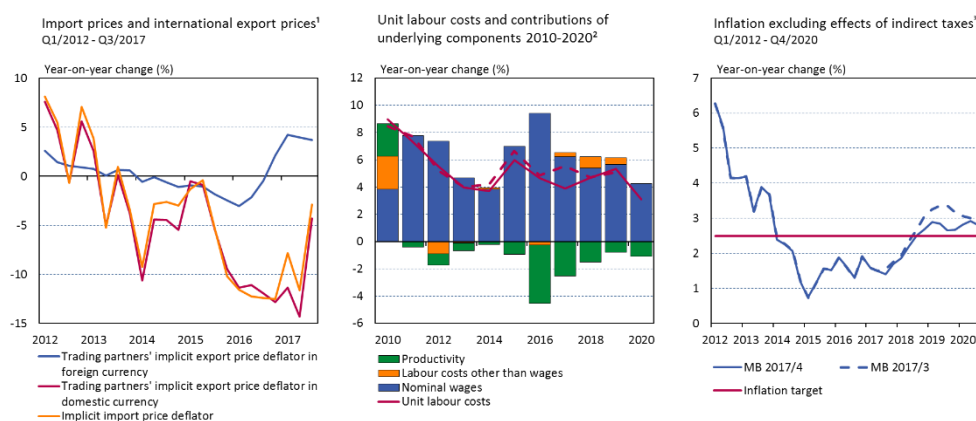
Chart 2



The fact that inflation has been low in recent years despite steep rises in wages and house prices stems primarily from two things: on the one hand, positive supply shocks in the form of strong export growth and improved terms of trade, which have pushed the exchange rate of the króna upwards, and on the other hand, price deflation in international goods trade. Import prices have therefore fallen steeply in krónur terms, as can be seen at the left in Chart 3. What would happen when this imported deflation turned around was always a source of concern. Such a development now appears to be on the horizon, as can be seen in the chart. But fortunately, the rise in unit labour costs seems to be losing pace, as can be seen in the chart at the centre, and house prices appear to have

peaked. The inflation outlook is therefore favourable, as can be seen in the chart at the right, which looks past the changes in value-added tax that could possibly be implemented in the near future.

Chart 3



“Missing” inflation

Headline inflation has been below the Central Bank’s target for nearly four years, even though the negative output gap closed and then turned positive some time ago and wages have risen well in excess of what, in an average year, would be deemed consistent with the inflation target.

This is not a unique case, however. In international circles, there is widespread discussion of “missing” inflation, which generally refers to the fact that wage rises are astoundingly small given the business cycle position in the country concerned. For example, countries as dissimilar as the US and Sweden are considered to be at full employment, yet wage increases are smaller than is consistent with the inflation target. In some countries, such as the US, this may be partly because the slack in the labour market is actually larger than conventional measurements indicate, as the labour participation rate is historically rather low. But this does not tell the whole tale, and in some countries it is not a very robust explanation. Given how widespread this phenomenon is, and given that it is in some respects independent of domestic conditions and economic policy, there are a number of indications that global factors such as increased cross-border mobility of labour and other production factors, international value chains, and the existence of a large excess labour force in some emerging market economies play an important role in it.

An underestimated slack in the labour market is hardly a factor in Iceland, as the labour participation rate is at a historical high and wage rises are substantial. Labour importation and indirect pressures from an unutilised lower-income labour force in other countries have clearly had a dampening effect on wage increases, however. Even so, inflation is low. This is true of

other economies as well. But it is less of a puzzle than wage developments in industrialised countries overall: global trends have been favourable to them, as can be seen in improved terms of trade and rising exchange rates. It is well known that this can create conditions where strong GDP growth and sizeable pay rises can coincide for a time with low inflation. And one difference between Iceland and many other industrialised economies is that in other countries there have been concerns that inflation expectations would fall too steeply and become anchored below target.

In order to place Iceland in this context, let us look at Chart 4, which gives some relevant metrics for several small and medium-sized inflation-targeting countries.

Chart 4

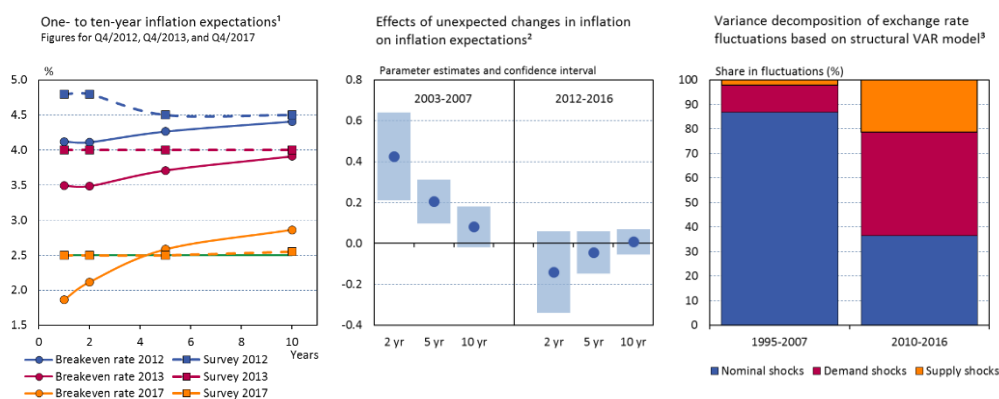


In this context, some of the discussion has centred on the extent to which low inflation is a problem if it is paired with robust GDP growth and full capacity utilisation, particularly if these are a result of positive supply shocks. In that case, perhaps the problem lies in how the inflation target is presented and understood. This will call for more flexibility and a longer horizon for the target, which was one of the proposals explored in the Central Bank's 2010 report on monetary policy in post-capital controls Iceland.¹

Monetary policy milestones

I mentioned earlier the success we have had with monetary policy – success that was visible a year ago and is even more obvious now. This past September, the Central Bank of Iceland issued a *Special Publication* entitled *Monetary policy based on inflation targeting: experience since 2001 and post-crisis changes*.² In addition to discussing the topics in the title, the report maps out this success with monetary policy. Chart 5 shows what that entails: inflation expectations are at target, unexpected changes in inflation that strongly affected short- and long-term inflation expectations in the past no longer do so, and movements in the exchange rate of the króna function much more as shock absorbers and less as sources of shocks than they used to. In short, monetary policy with a flexible exchange rate is much more successful now than it had been before 2012, when the Bank published its report entitled *Iceland's currency and exchange rate policy options*.³

Chart 5



¹ *Special Publication* no. 4, Monetary Policy in Iceland after capital controls. Report from the Central Bank of Iceland to the Minister of Economic Affairs, December 2010:

https://www.sedlabanki.is/library/Skraarsafn/Serrit/Peningastefnan_eftir_hoft.pdf

² *Special Publication* no. 11. Monetary policy based on inflation targeting: experience since 2001 and post-crisis changes, September 2017:

https://www.sedlabanki.is/library/Skraarsafn/Serrit/Serrit_nr_%2011.pdf

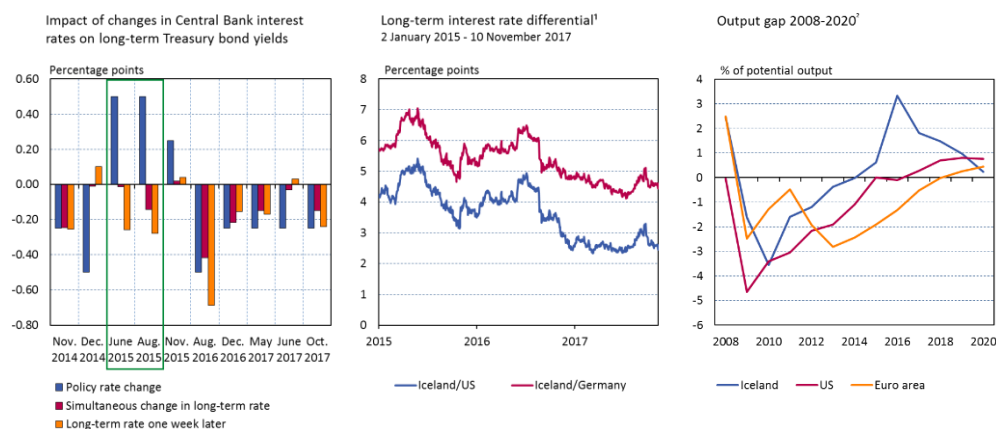
³ *Special Publication* no. 7. Iceland's currency and exchange rate policy options, September 2012: <https://www.sedlabanki.is/library/Skraarsafn/EMU-skýrsla/Valkostir%20íslands%20í%20gjaldmiðils-%20og%20gengismálum.pdf>

Capital flow management tool

There have been proposals in the media recently to the effect that the special reserve requirement on foreign capital inflows for investment in the bond market and in high-yielding deposits be immediately reduced or even eliminated. In a Box in the newly published *Monetary Bulletin*, the Bank discusses this special reserve requirement. It does not agree with these proposals.

The special reserve requirement has functioned as intended, and monetary policy transmission along the interest rate channel has improved, as can be seen at the right in Chart 6. Without it, monetary policy transmission would have been shifted in greater measure to the exchange rate channel, leading to a stronger appreciation and increased exchange rate volatility, which would not have been terribly popular under current conditions. Although the goal is to lift the special reserve requirement, conditions do not warrant it as yet. It will probably be necessary to scale it back in increments as demand pressures in the domestic economy recede and growth in trading partner countries gathers more momentum. Current forecasts indicate that this will happen, as can be seen at the right in the chart. Long-term interest rates will reflect this, and the long-term interest rate differential will narrow.

Chart 6



Another important factor is that it is unclear what benefit the investments affected by the capital flow management measure have for Iceland at present. The Treasury's borrowing need is limited in historical context, and strictly speaking, the Treasury does not need the funds generated by the bonds in question. If the special reserve requirement were not in effect, the Central Bank would probably have to hold larger foreign exchange reserves so as to mitigate the risk associated with carry trade-related inflows and the potential for sudden outflows. This would be quite costly, as the global market returns on the reserves are unusually low at present. At the same time, foreign investors can expect attractive returns on Icelandic Treasury bonds, and the more stable the króna, the greater the risk-adjusted interest rate differential. In order to reduce

that differential, the Central Bank would therefore need to allow increased exchange rate fluctuations, which would also exacerbate the risk faced by residents. Under current conditions, it can even be argued that for the Icelandic economy, the net benefit from such inflows is negative.

Nevertheless, the aim is to lift the special reserve requirement as soon as conditions warrant it and that it will not, as a general rule, be used under normal conditions. Even so, the Central Bank has considered it important to be able to activate it if the need arises. The special reserve requirement would then be a third line of defence, to support conventional economic policy and micro- and macroprudential tools.

In order for this to be possible after the capital controls have been lifted in full, a new statutory foundation (other than the Foreign Exchange Act) must be found for the special reserve requirement, which is primarily a monetary and macroprudential policy instrument. Furthermore, the efficacy of the special reserve requirement must be ensured once speculative derivatives trading in krónur has been re-authorized, as full liberalisation implies. The Central Bank is currently reviewing the technical foundations for the special reserve requirement and preparing proposals for statutory amendments pertaining to its application.

Exchange rate fluctuations

The new issue of *Monetary Bulletin* contains a Box on fluctuations in the exchange rate of the króna in international context. That article presents several points that should be borne in mind in any discussion of monetary policy and possible modifications to the monetary policy framework, including exchange rate policy. They are as follows:

- Short-term exchange rate volatility increased just after the capital controls were lifted, as had been expected and as the Monetary Policy Committee had pointed out in advance in its statements. This volatility has subsided in recent months (see the right side of Chart 7).
- If we look beyond the aftermath of the pegged exchange rate regime, the financial crisis, and the capital controls regime, it cannot be seen that the short-term fluctuations of the Icelandic króna have been vastly larger than other Nordic krónur that have flexible exchange rates, or commodity-exporters' currencies. These currencies also have periods of peak volatility.
- Long real exchange rate cycles are a well-known phenomenon, also in countries with a fixed nominal exchange rate (Chart 8).
- As has previously been noted, exchange rate movements have been more effective as shock absorbers in recent years than they were previously. Although more effective and more credible monetary policy plays a part in this, what is probably more important is that the capital controls – and now,

the capital flow management measure – have mitigated volatile capital flows, which can undermine economic stability, as experience has shown.

Chart 7

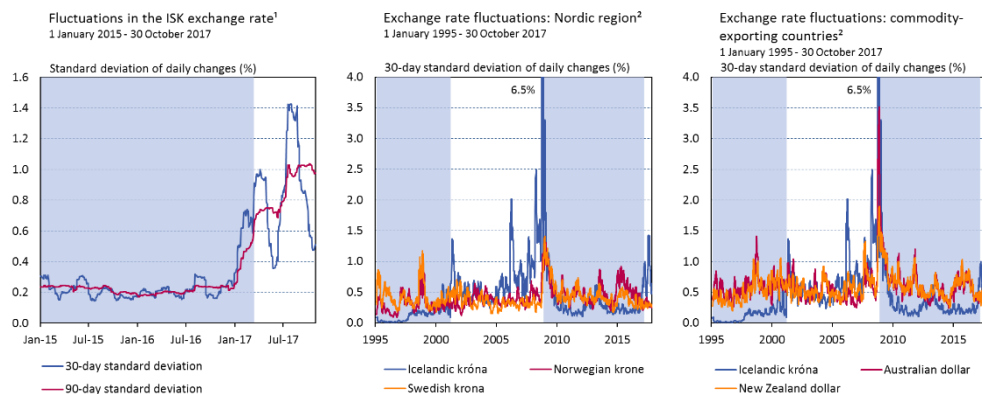
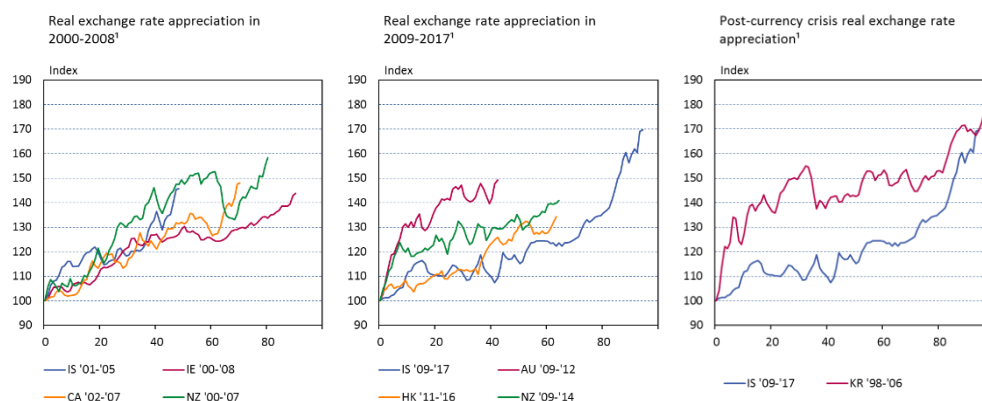


Chart 8



Review of the monetary policy framework and currency and exchange rate policy options

In closing, I would like to focus on the ongoing review of Iceland’s monetary policy framework and currency and exchange rate policy options.

In the recent past, I have emphasised how important it is that this discussion should take into account what monetary policy can and cannot do. In the long run, monetary policy can deliver price stability, and in the short run it can also mitigate the effects of shocks and reduce fluctuations in output and employment. But monetary policy cannot have a long-term impact on the real exchange rate. As such, it can do little to mitigate the crowding-out effect of strong growth in a new export sector. If it tried to, the effect would be only temporary, and it would come at the expense of sacrificing the objectives with which monetary policy has been entrusted – objectives that it can achieve. Industrial and fiscal policies can have such a real impact over the long term, however, and it is to them that concerned parties should turn.

But it is possible to choose from among various options on the spectrum between a rigid peg and a free-floating exchange rate. And it is possible to adopt another currency, either unilaterally or in bilateral or multilateral cooperation.

These were the options explored in the Central Bank's 2012 report.⁴ The conclusion was that a unilateral peg with unrestricted capital flows could run aground, as it did in so many economies after capital movements were liberalised further in the 1980s and 1990s. A firmer peg such as a currency board could pose risks to financial stability, and the same was considered true of unilateral adoption of another currency. It was deemed highly uncertain – and actually unlikely – that bilateral adoption of another currency would be on offer anywhere.

That left two possibilities: joining the eurozone after a negotiated agreement and continuing with a flexible exchange rate and an inflation target. The problem was that there were drawbacks to both. The financial crisis had uncovered flaws in the design of the eurozone, and it also came to light that political support for eurozone membership was lacking. Independent monetary policy and a flexible exchange rate had not been very successful.

Has something changed? The euro area is still putting in place the reforms deemed necessary for it to function smoothly, and it does not seem to me that political support for membership has increased significantly since the Bank's report was issued. But various reforms have been made to monetary policy conduct in Iceland, and financial stability policy has been vastly improved. Much of what I have called *inflation targeting plus* has already been put in place. And in the past few years, we have seen that independent monetary policy can work effectively, also in Iceland. This is where we are now. That need not mean that we will be here for the indefinite future. There is no eternal monetary solution, and various options develop over time.

⁴ See reference in Footnote 3.