



Seðlabanki Íslands

Nexus between monetary and fiscal policy

Iceland's pre- and post-crisis experience

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Lessons on monetary and fiscal policy mix from Iceland



- Stabilisation policy faced very different policy challenges in the pre- and post-crisis periods

Pre-crisis period	Stemming overheating of economy, inflation pressures and asset price bubbles in the face of large demand shocks and rapidly growing banking sector
Post-crisis period	Stabilising economy on the back of a severe banking and currency crisis, exchange rate and inflation stabilisation, private sector balance sheet restructuring, and economic recovery



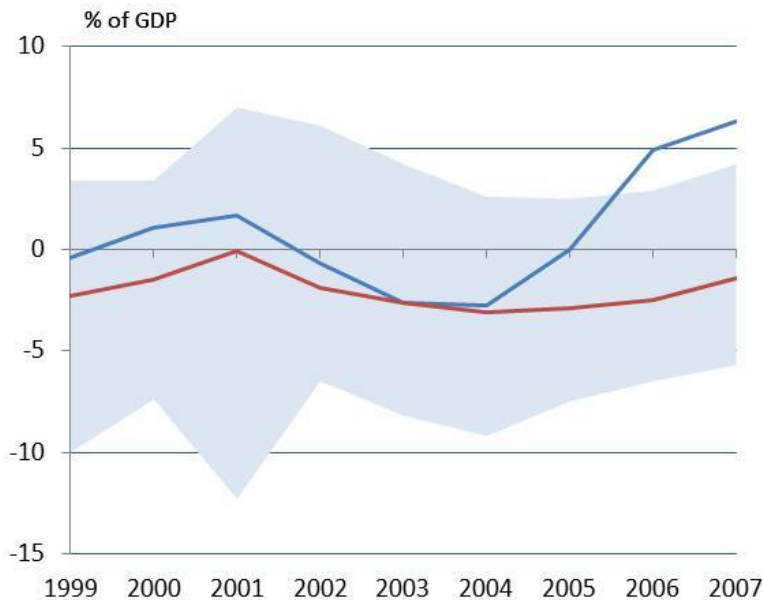
Lessons from the pre-crisis period

Countercyclical fiscal policy? ...



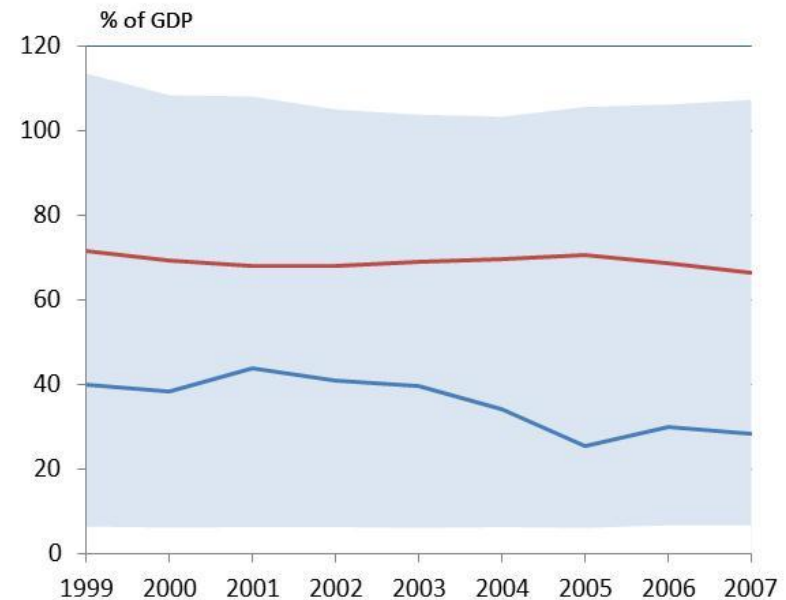
- With healthy surpluses and low debt, fiscal policy seemed prudent and countercyclical in the run up to the crisis
- Nevertheless, Iceland's poor inflation performance and large imbalances in the pre-crisis era was partly due to insufficient co-ordination between monetary and fiscal policy

General government net lending
in Iceland and EMU-15 1999-2007



High-low range of EMU-15 countries
Iceland
EMU-15

General government gross debt
in Iceland and EMU-15 1999-2007



High-low range of EMU-15 countries
Iceland
EMU-15

... Not really on closer inspection

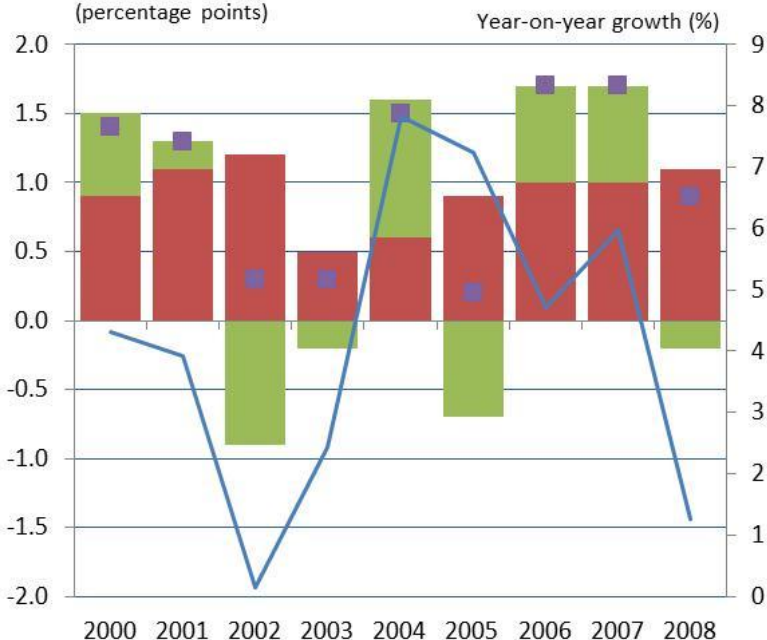


- Large increases in public spending and significant tax cuts
- Large government induced investment in power-intensive sector and changes in mortgage market lowering mortgage rates and making equity withdrawal easier
- At the same time, the Central Bank was hiking rates to counter inflation pressures

Public expenditure and economic activity

2000-2008

Contribution to GDP growth
(percentage points)

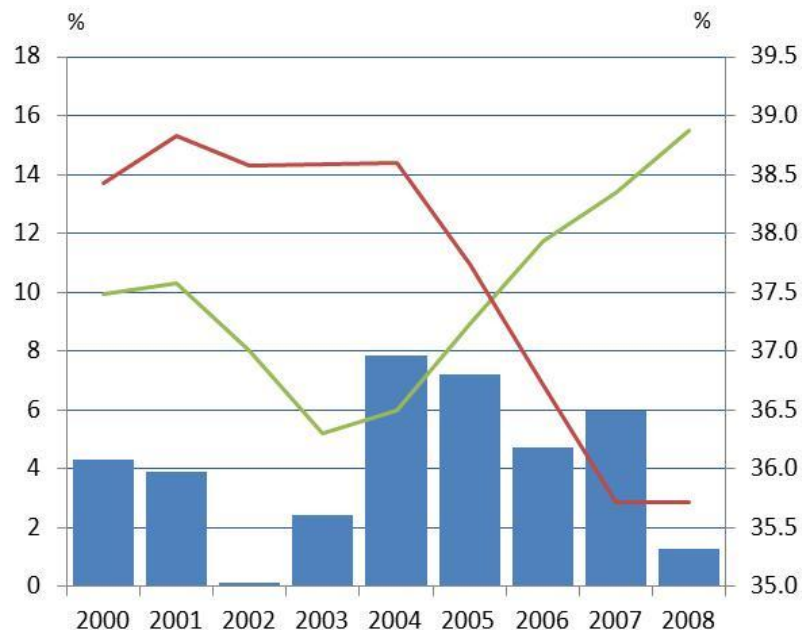


- Government investment (left)
- Government consumption (left)
- Public final spending (left)
- GDP growth (right)

Sources: Statistics Iceland, Central Bank of Iceland.

GDP growth, taxes and monetary policy

2000-2008¹



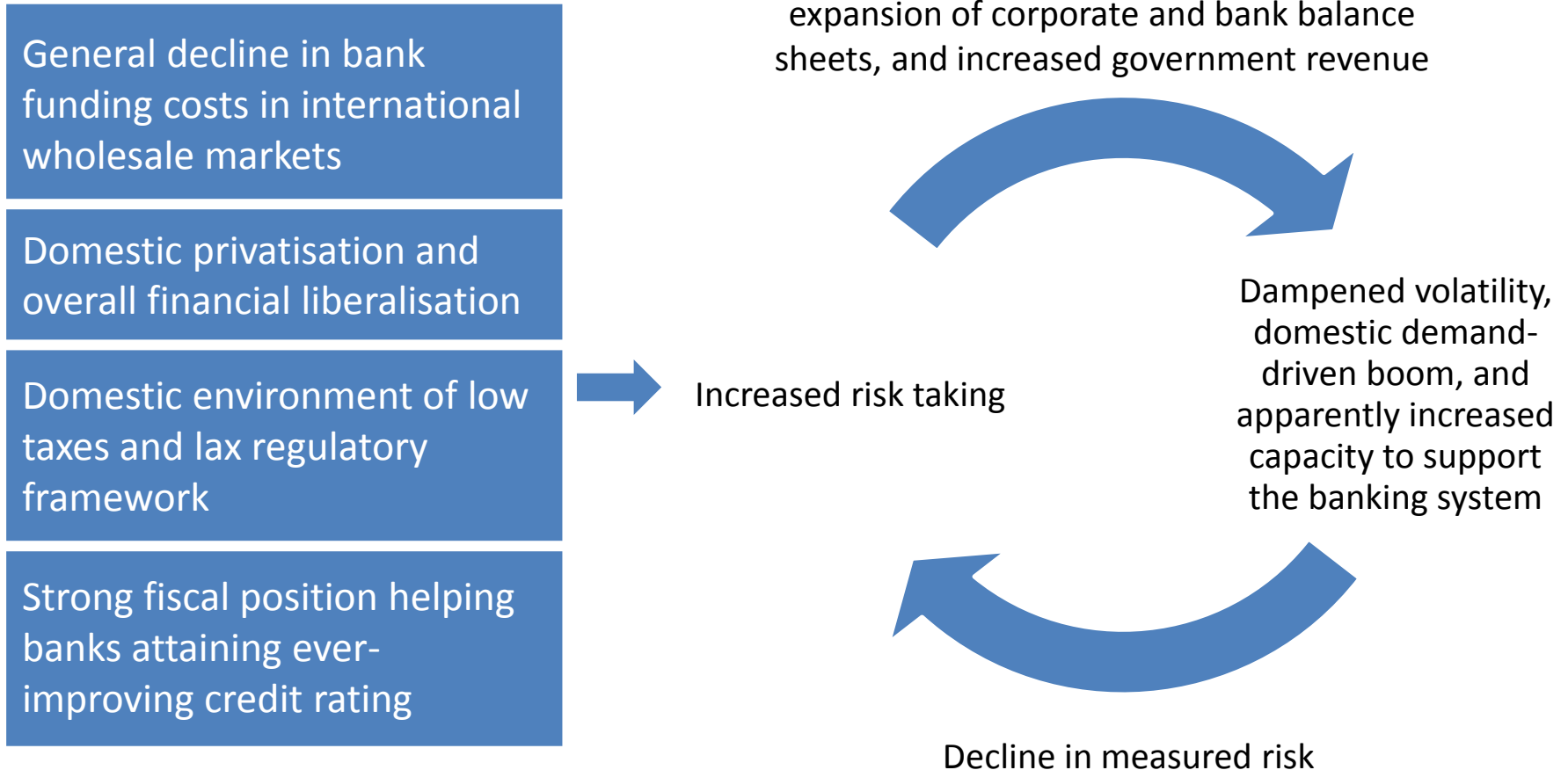
- GDP growth (left)
- Central Bank policy rate
- Personal income tax rate (right)

1. Tax rate is the weighted average of the personal income tax rate and the high income surcharge.

Sources: Central Bank of Iceland, Statistics Iceland.

Risk-taking feedback underestimated

Fed the boom before suddenly reversing





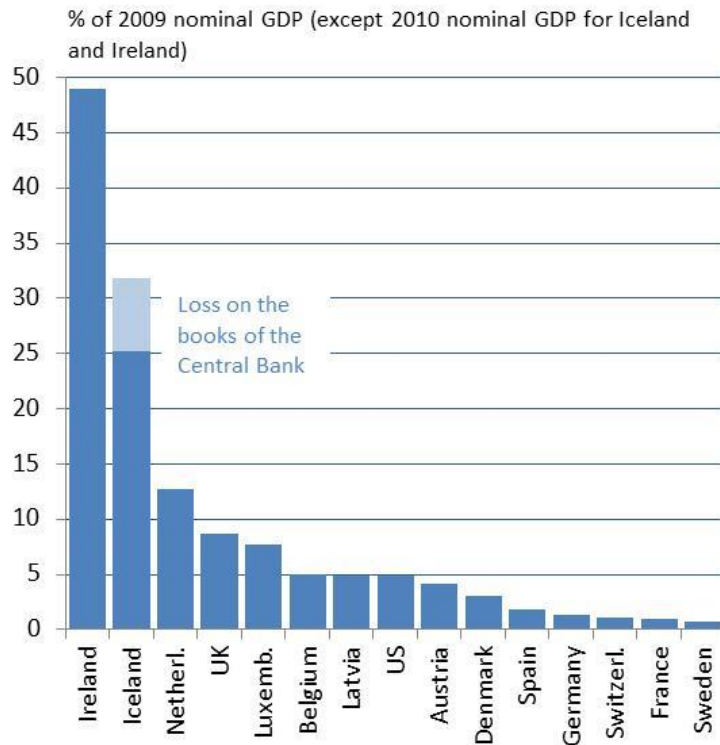
Lessons from the post-crisis period

Crisis hit government finances hard



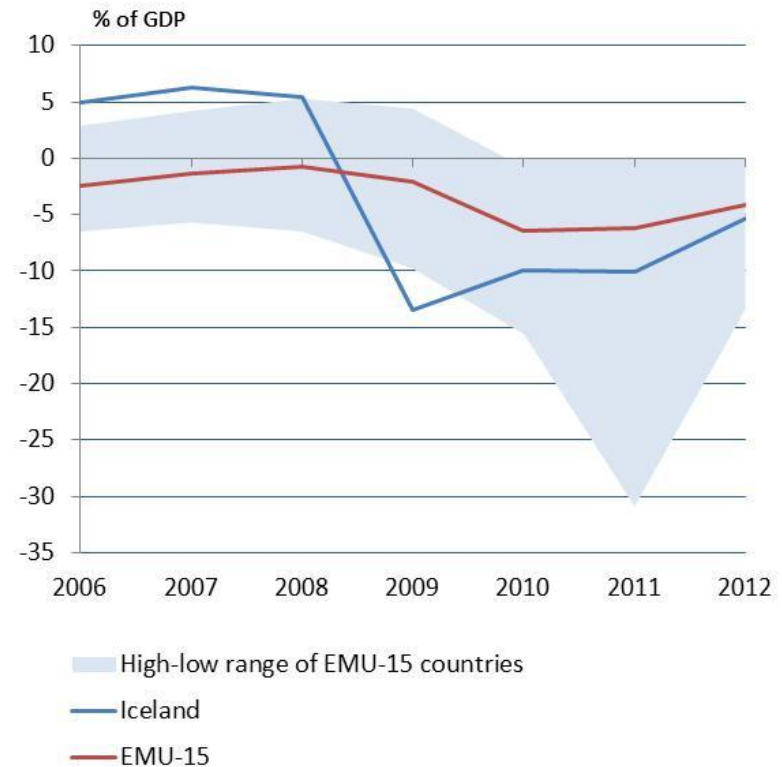
- With its huge imbalances and oversized banking system, the financial crisis hit Iceland hard
- Central Government direct fiscal costs estimated around 25% of GDP (including the Central Bank capital write-down pushes this up to 32%) – second only to Ireland
- Led to a large fiscal reversal: from a surplus of 5.4% in 2008 to a deficit of 13.5% in 2009

Direct fiscal costs of the financial crisis



Sources: Laeven and Valencia (2010), "Resolution of banking crises: The good, the bad, and the ugly", *IMF Working Paper*, no. 10/146, OECD (2011), except *OECD Economic Surveys: Iceland*, and The Icelandic National Audit Office (2012). Fiscal cost of recapitalizing financial and Government institutions following the financial crisis. Report to Parliament, for Iceland and Ireland.

General government net lending in Iceland and EMU-15 2006-2012



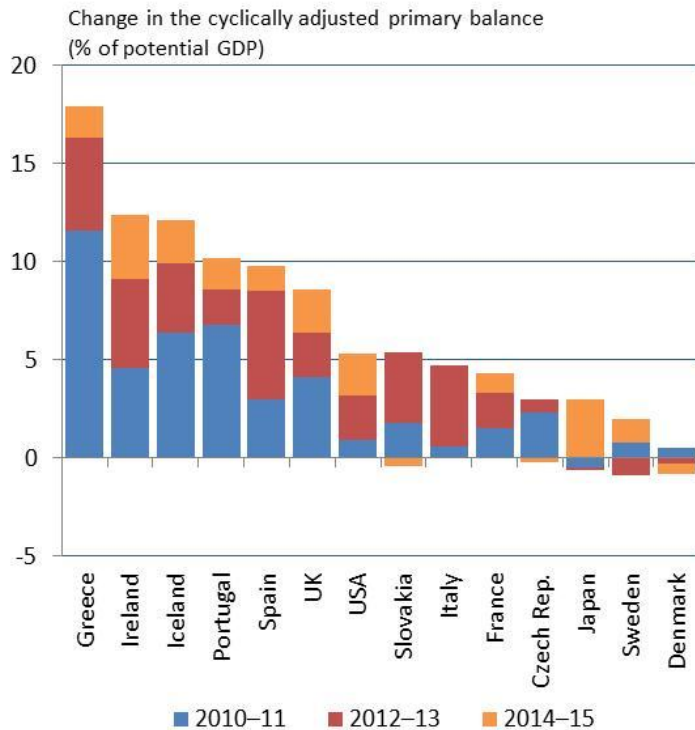
Sources: Eurostat, Statistics Iceland.

Consolidation with monetary support ...



- Consolidation of 12% of GDP in 2010-15 (10% in 2010-13; second only to Greece among developed countries)
- Front-loaded – although automatic stabilisers were allowed to operate fully in 2009
- Consolidation supported by low real policy rate, especially from 2011

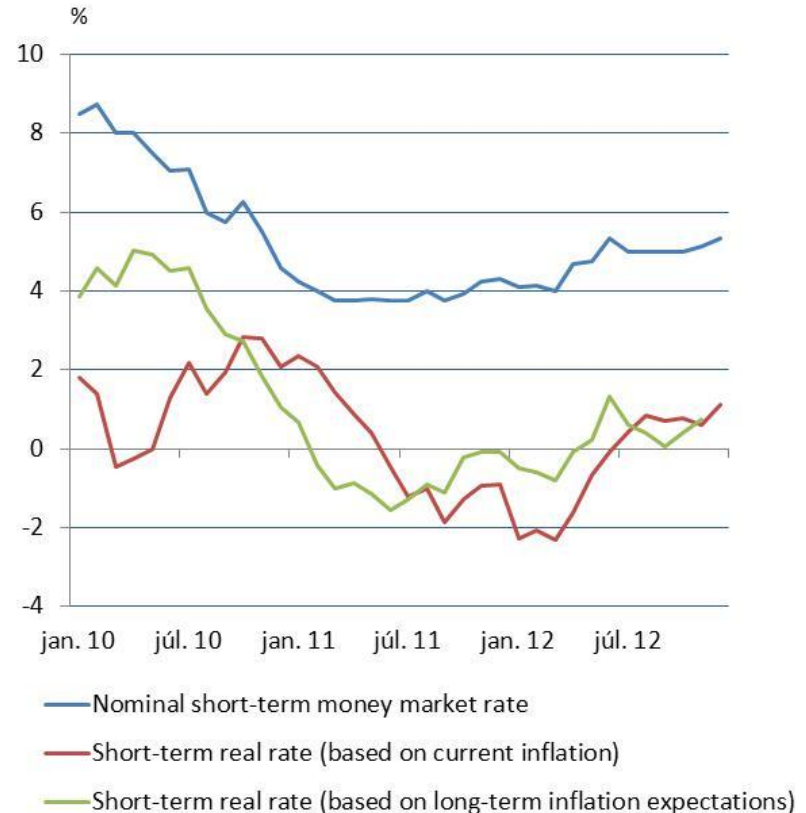
International comparison of fiscal adjustment in advanced economies in the global crisis¹



1. Fiscal adjustment in 2010-11 refers to changes in the cyclically adjusted primary balance (CAPB) in 2011 compared to 2009; 2012-13 refers to the change in the CAPB in 2013 compared to 2011; and 2014-15 refers to the change in the CAPB in 2015 compared to 2013.

Source: IMF.

Monetary policy stance 2010-2012



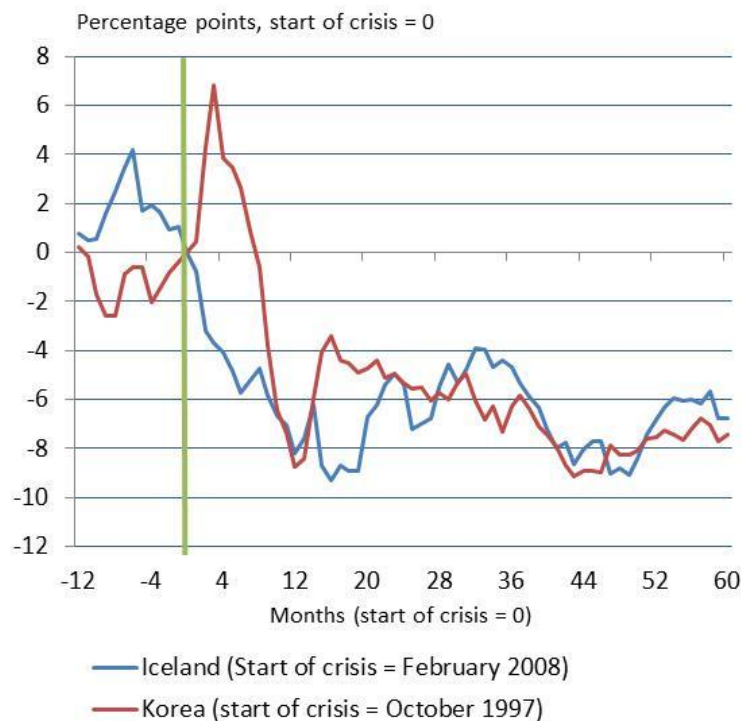
Sources: Statistics Iceland, Central Bank of Iceland.

... And helped by capital controls



- Capital controls introduced to stabilise currency, thus preserving balance sheet health and stabilising the economy
- Also helped with fiscal consolidation as policy rates could be lower than otherwise and the government could issue bonds to “captive savers” – both reducing the financing cost of the deficit

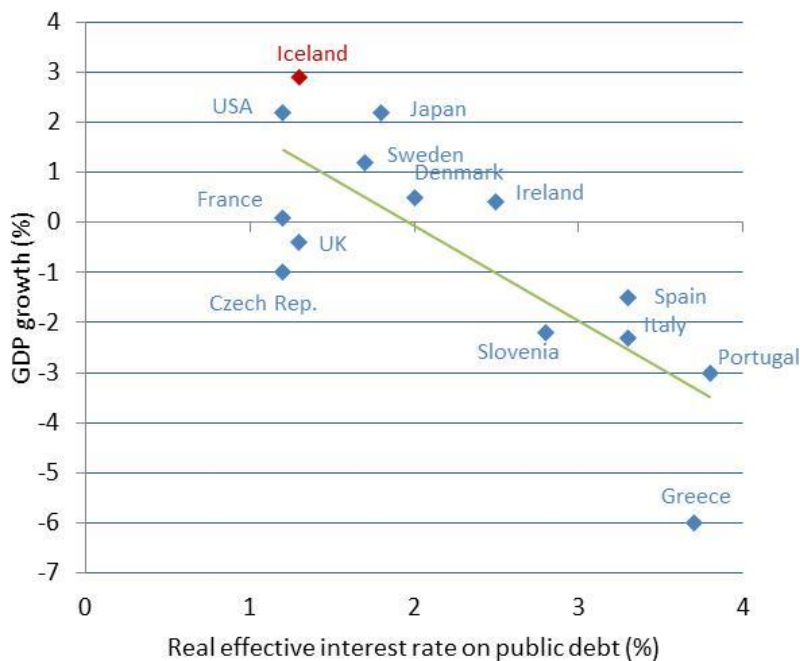
Real short-term interbank interest rates in two twin-crises - Iceland and Korea¹



1. The currency crisis in Korea is assumed to have started in October 1997 when pressures on the won started to escalate. The currency crisis in Iceland is assumed to have started in February 2008 when the foreign exchange swap market collapsed.

Source: OECD.

Real effective interest rate on public debt and GDP growth in 2012¹



1. Based on IMF estimates and projections in *Fiscal Monitor*, October 2012. Effective real interest rates are defined as the ratio of interest payments over the debt of the preceeding period.

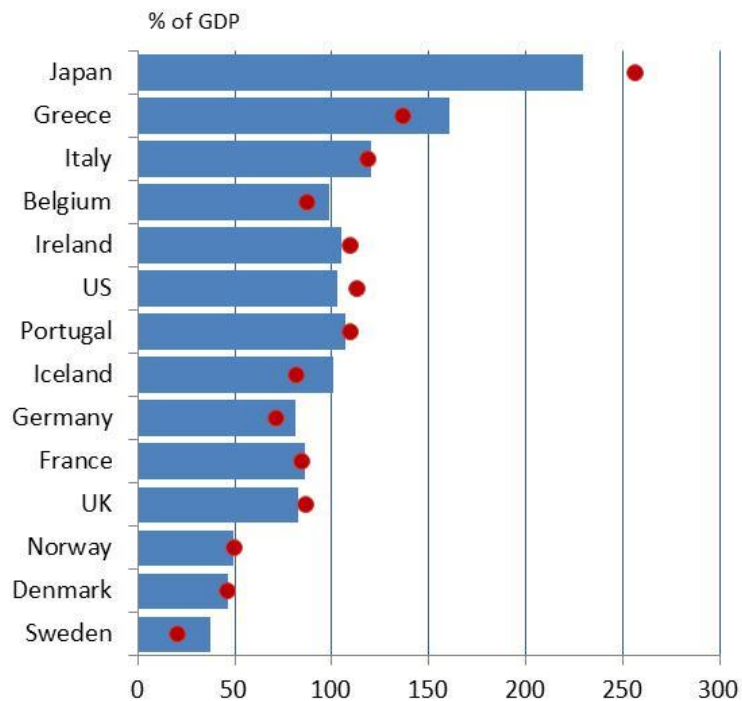
Source: IMF.

Declining debt and risk premia



- Recovery since mid-2010 has helped stabilising debt ratio – and ratio expected to decline from 2011
- Helped by rising nominal GDP, relatively loose monetary policy, capital controls and declining default risk premia on public debt

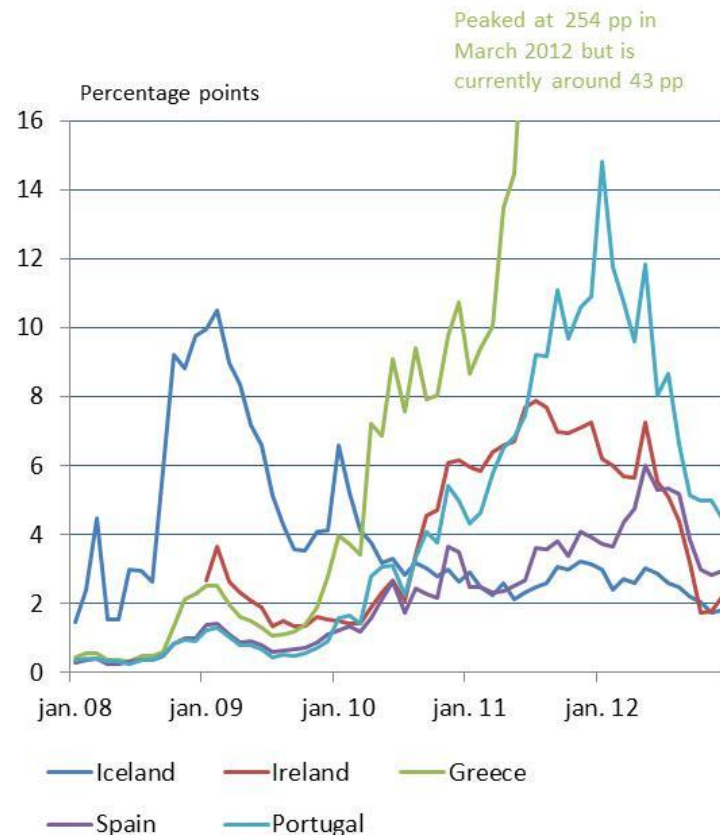
General Government gross debt in various industrial countries for 2011 and 2017¹



1. IMF forecasts for 2017 are shown with red points.

Sources IMF.

CDS spreads



Source: Bloomberg.

Fiscal multipliers in Iceland

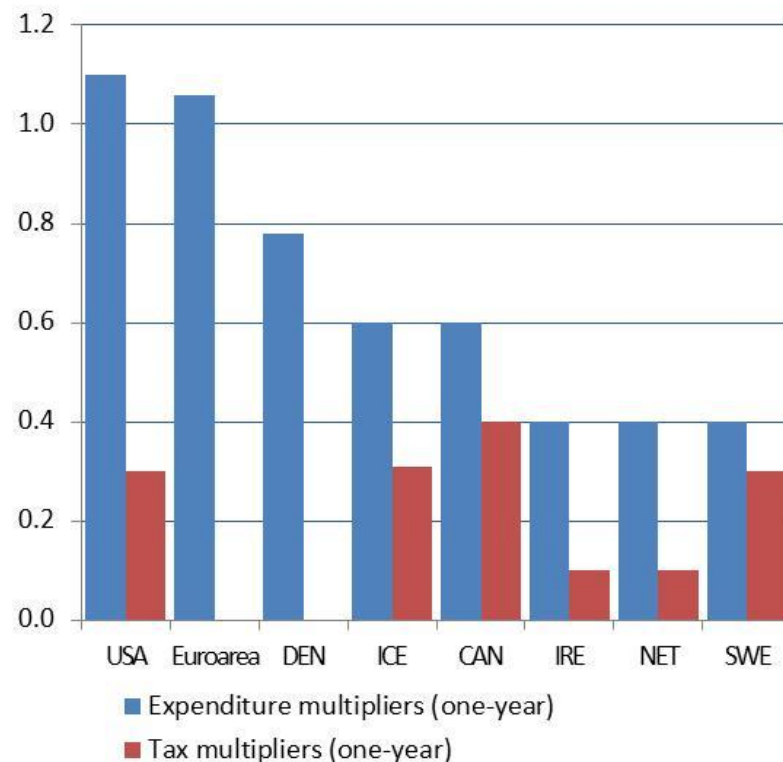


Pre-crisis estimates are relatively small ...

- Fiscal multipliers seem relatively small in Iceland – in line with other small open economies with a flexible exchange rate
- But has the financial crisis changed this?

Factors that could have increased multipliers	Output slack
	Import compression
	Malfunctioning financial system
Factors that could have decreased multipliers or prevented a post-crisis rise	Accommodative monetary policy unconstrained by zero lower bound
	Capital controls
	Pension fund pay-outs
	Debt write-offs

International comparison of estimated fiscal multipliers¹



1. The figure shows the effects of a permanent (or 5 year) fiscal policy shock amounting to 1% of GDP, assuming an endogenous monetary policy response (except for the euro area and Denmark).

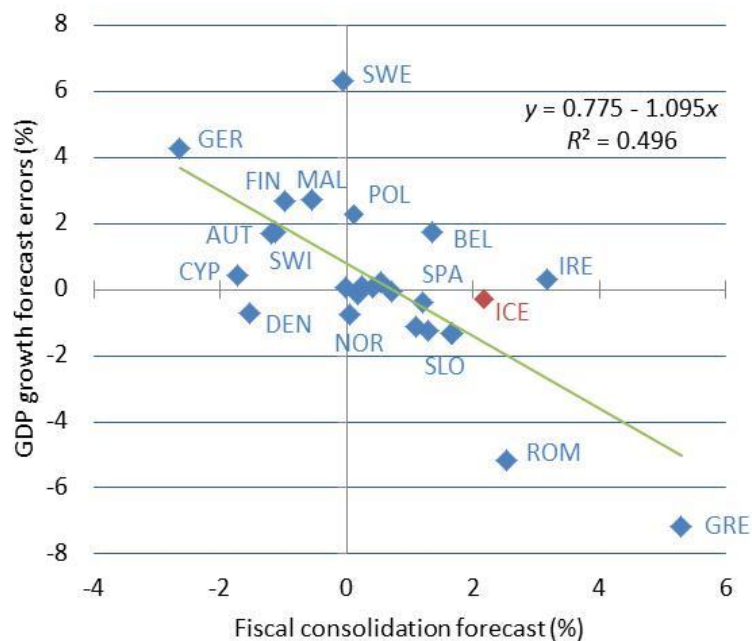
Sources: HM Treasury (2003), Perotti (2006), Danmarks Nationalbank, Fagan and Morgan (2005), Central Bank of Iceland.

... And have probably not changed



- A recent IMF study suggests a link between size of consolidation and weaker-than-expected activity – suggesting that fiscal multipliers were underestimated in the consolidation phase
- 2010-11 growth and consolidation in Iceland broadly as forecasted – suggesting that multipliers have not changed significantly

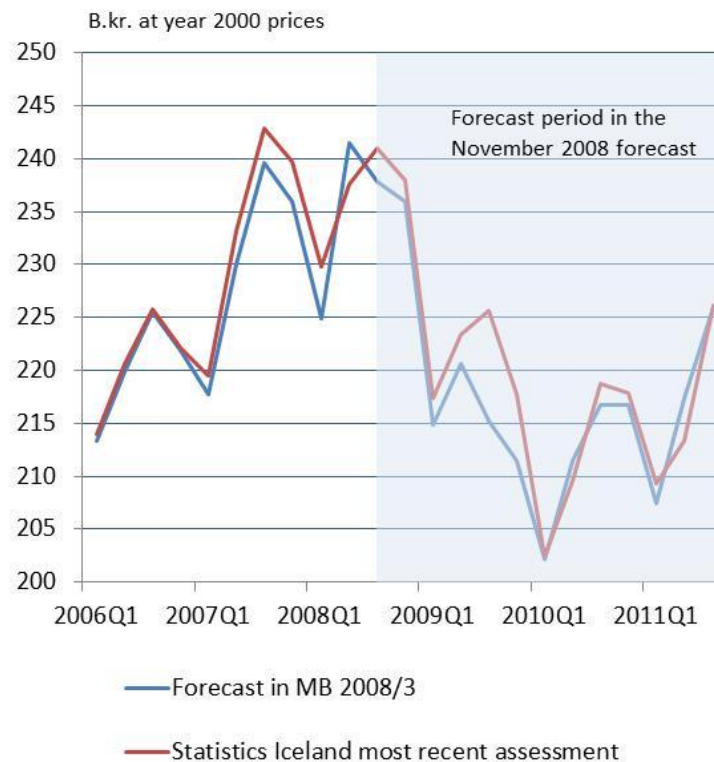
Growth forecast errors and fiscal consolidation forecasts in 26 European countries



The figure plots forecast errors for real GDP growth in 2010 and 2011 relative to forecasts made in the spring of 2010 on forecasts of fiscal consolidation for 2010 and 2011 made in spring of 2010.

Source: Blanchard, O., and D. Leigh (2013). Growth forecast errors and fiscal multipliers. *IMF Working Paper*, WP/13/1.

Gross domestic product - comparison with forecast in *Monetary Bulletin* 2008/3



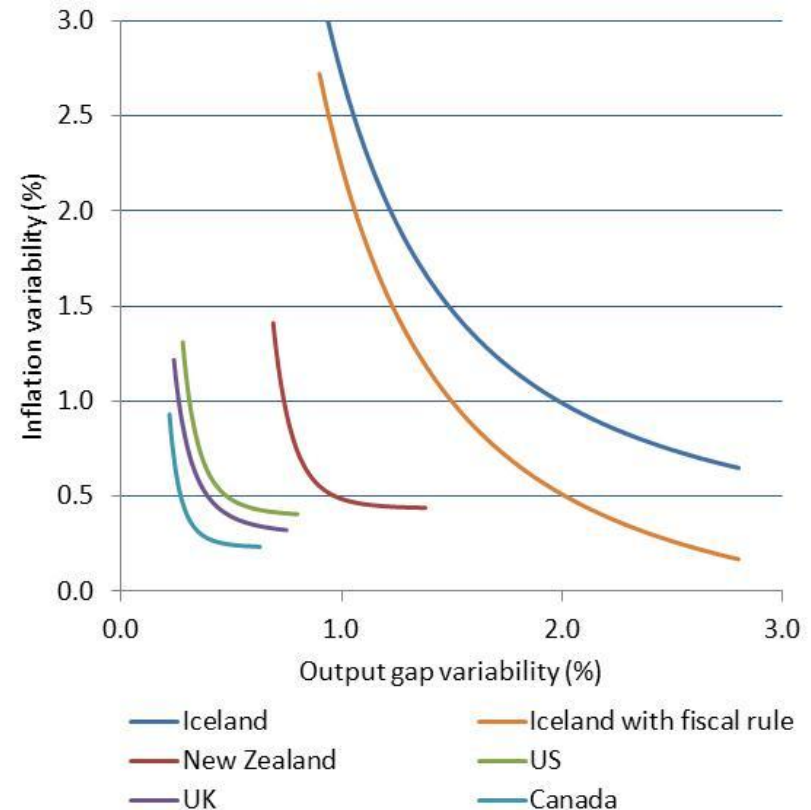
Sources: Statistics Iceland, Central Bank of Iceland.

Reforms important to improve policy trade-off



- Although fiscal consolidation seems on track, potential headwinds exist
 - Some fragile income assumptions in the latest budget
 - Increasing spending pressures with general elections coming up
- But broad-based support for fiscal reform...
 - A new bill on organic budgeting and formal fiscal rules at national and sub-national levels
- ... Together with monetary reform...
 - Inflation-targeting-plus: leaning against asset prices, more active exchange rate interventions, and macro-prudential tools
- ... Should improve unfavourable policy trade-off
- But caution warranted
 - Should be modest in expectations of success
 - Fiscal rules have been tried before
 - Battle-lines between fiscal and monetary become more blurred
 - Risk of fiscal dominance?
 - Risk of losing focus on attaining price stability?
 - Central bank independence under threat?

Efficient monetary policy frontiers



Source: Honjo, K., and B. Hunt (2006). Stabilizing inflation in Iceland. *IMF Working Paper*, WP/06/262.