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## Dead-end discussion on monetary policy

The Central Bank of Iceland's monetary policy has been the target of wide ranging criticism recently, in the broader context of discussion concerning Iceland's future monetary and exchange rate policy arrangements. This criticism is understandable in view of the fact that inflation has long exceeded the Bank's inflation target of 2.5%, which was announced in the joint declaration by the Central Bank and the Icelandic government in 2001. The Bank has no reason to complain about being criticised. A thorough analysis of what has gone wrong in the past is a precondition for more successful policy in the future.

### *Incoherent discussion*

The fact that inflation has been **above** the Central Bank target, and not below it, makes some of this criticism harder to understand, however. The debate on the subject has been incoherent and characterised by exaggeration, to say the least. It mixes criticism of monetary policy within the current framework together with the discussion of conceivable future monetary policy arrangements. In many instances, the conclusions that have been drawn are utterly illogical: for example, some critics appear to conclude that because inflation has been above target levels, monetary policy has been too tight, though it would be more appropriate to assume the opposite. Some argue that policy interest rate changes are a blunt blade in the fight against inflation and conclude that the Central Bank should wield that weapon with greater leniency. Yet it would be more logical to conclude that a blunt tool requires greater force. In spite of this, the very voices that have argued that the Central Bank's arsenal contains nothing but dull-edged blades have simultaneously demanded that the Central Bank spread its focus over multiple objectives rather than concentrating on price stability. Why ineffective instruments that cannot achieve a single goal should be deemed potent enough to attain a wide range of objectives is a mystery, however. A lively exchange of opinions on monetary policy is a welcome thing, but more coherent arguments would be more welcome still.

In order to disentangle the web of arguments that have been presented recently, it is helpful to divide the discussion into three separate categories. First, it is necessary to determine why inflation has deviated from target consistently since inflation targeting was adopted and to evaluate the overall success of inflation targeting to date. Second, it is necessary to assess what the Central Bank could have done differently in order to carry out its task more successfully. In this context, it is also appropriate to consider what other

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agents, the government in particular, could have done in order to soften the negative side effects of a tight monetary policy. Third, it is necessary to assess whether the current monetary policy framework needs improvement. This may include discussion of minor modifications of the inflation target – e.g. whether it is too high, too low, or incorrectly defined – or a more fundamental overhaul of the monetary policy framework, such as the adoption of a fixed exchange rate policy or complete monetary integration. A newspaper article is not the proper place to answer all these questions exhaustively. My aim with this article, however, is to channel the discussion onto a more logical and reasoned path than it seems to have taken until now.

*An experiment in economics – How much shock can the monetary policy of a small country with a floating exchange rate withstand?*

Iceland's economic policy over the past several years represents a remarkable economic experiment. The central bank of the world's smallest country with a floating exchange rate is assigned the task of administering monetary policy in accordance with an inflation target at the same time that the "largest development project in Icelandic history" is being carried out. At the same time, the financial system has undergone changes that stimulate demand dramatically. As if that were not enough, taxes have been cut. And to make the Central Bank's job even more difficult, all these things happened at a time when global interest rates were at an all-time low. Though all of this is common knowledge, there is reason to bear these factors in mind, for it seems they have been forgotten in the barrage of criticism that has been aimed at the Central Bank in the past few months.

Since the Central Bank adopted inflation targeting in 2001, inflation has averaged 4.7% based on the 12-month CPI increase, which was the criterion set forth in March 2001 declaration by the Bank and the government. Inflation has also been quite volatile during this period, ranging from 1.6% to 9.4%. When all is said and done, the Central Bank, whose primary task is to maintain price stability, has only one tool with which to achieve its objective. Although there are other potential administrative tools, such as changes in reserve requirements or intervention in the currency market, they are less direct than changes in the policy interest rate, and their effectiveness is ultimately transmitted along the interest rate channel. The end result is therefore very similar to that achieved through changing the policy rate. Therefore, if the Central Bank has been unsuccessful in keeping inflation close to target, it is difficult to conclude otherwise than that the policy rate has, on average, been too low. A comparison of the Central Bank's policy rate path and a path calculated using the so-called Taylor rule indicates likewise.

*Reasons for errors and means of improvement*

There are numerous reasons why the policy rate has sometimes been lower than seems appropriate in retrospect. Forecasts (by the Central Bank and others) and preliminary national accounts estimates underestimated growth in domestic demand, especially in 2004. In some instances – for example, in 2006 – the preliminary figures proved farther off the mark than the forecasts prior to their release. The degree to which the deviations can be traced to incomplete data, incorrect models, or erroneous assessment by the Central Bank concerning the state of the economy and the transmission of monetary policy is the subject of an investigation that is still incomplete. Most likely, however, all

of these factors have contributed to a degree. To some extent, the deviations can simply be explained by an inevitable and ever-present uncertainty, but it is important to continue improving the conduct of monetary policy where there is potential for improvement. The staff of the Central Bank continue to develop models in order to improve their forecasts and have made considerable strides in the last two years. Methods for improving preliminary national accounts estimates are also under scrutiny. Moreover, in March 2007 the Central Bank began publishing the policy interest rate path deemed by staff to be consistent with the inflation target, with the aim of making the transmission of monetary policy more effective and its conduct more transparent.

Despite all this, domestic criticism of the Central Bank has not been directed at the obvious: the fact that, at times, the policy rate appears to have been too low. Indeed, many critics have maintained, contrary to views expressed by the IMF, the OECD, and the Central Bank itself, that the policy rate has long been far too high. Even some of those who, in 2005, criticised the Central Bank for raising interest rates too late – probably with some justification – now seem to have turned their coats. This is even more astounding in view of the fact that underlying inflation, at nearly 7%, is far above the inflation target and the labour market is stretched to its limits. Therefore, critics appear to be arguing either that the policy rate does not affect inflation at all or that the inflation metrics used by the Central Bank are wrong.<sup>2</sup> If the former is true, it raises serious questions concerning the fundamental choice of whether to maintain independent monetary policy or not. The latter, if true, could be corrected within the framework of current monetary policy. Let us address the latter argument first.

*Is monetary policy based on incorrect inflation measurements?*

As is the case with other central banks that have adopted an inflation target, the Central Bank of Iceland defined its target with reference to a broad-based index, the Consumer Price Index. It would be possible to base inflation measurements on an index that excludes volatile items, as some central banks have done. The rationale for this is that these volatile items, such as fuel prices, do not have a long-term effect on inflation and lie outside the scope of monetary policy. The conclusion drawn in 2001, when the inflation target was adopted in Iceland, was that the advantages of using a broad-based index outweighed the disadvantages. The recent criticism, however, is aimed primarily at the housing component, as it was in 2005.<sup>3</sup> The answer to the question of how to measure changes in the price of services related to owner-occupied housing is not unambiguous. Statistics Iceland uses one of four methods that are internationally recognised. Its method is not flawless from the standpoint of a central bank with an inflation target; for example, interest rate movements affect the calculation of owner-occupied housing prices. The sensitivity of housing costs to policy rate changes increased after calculation methods were changed in 2004. Furthermore, it is not possible to separate the effects of changes in

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<sup>2</sup> This reaction can conceivably be interpreted to mean that critics want a higher inflation target, though no one has said so outright. A change of that sort would make an immediate impact on inflation expectations without having any long-term effect on output growth and employment levels. To keep inflation stable at higher levels would require a higher nominal policy rate.

<sup>3</sup> The 12-month rise in the CPI excluding the housing component has averaged 3.3% since the adoption of the inflation target. Therefore, even by that measure, inflation has been too high and the policy rate too low.

land prices from changes in other components of the price of a housing asset, as might be desirable.

Problems of measurement notwithstanding, ignoring housing costs altogether in monetary policy deliberation is not an acceptable alternative, as it would exclude nearly one-fourth of households' cost of living. When the inflation target was defined in 2001, the pros and cons of excluding the housing component were considered. In addition to being a broader and better-known measure of the cost of living, the Consumer Price Index has the advantage of being a more stable measure, though many people seem to believe otherwise. Another benefit for forward-looking monetary policy is that housing price inflation appears to be a leading indicator of more broad-based inflation later on. When domestic demand increases rapidly in a small open economy, prices of non-traded goods and services that are sheltered from foreign competition tend to rise first, especially if supply is inelastic, as is the case with housing. If monetary policy responds to higher inflation with a policy rate hike, the result is usually a short-term appreciation of the currency. This constrains the price of traded goods and services. The opposite occurs when domestic demand diminishes. The effects of exchange rates and housing offset one another to some extent, and the result is an index that is more stable than its individual components. A further argument for targeting headline inflation is the fact that financial indexation, which is widespread in Iceland, is generally based on the Consumer Price Index.

The Central Bank is not opposed to reassessing, at the appropriate time, the various measures of inflation so as to determine which are most suitable. A sensible alternative, for instance, would be to use the Harmonised Index of Consumer Prices (HICP) when owner-occupied housing has been incorporated into it, as is planned. On the other hand, redefining the target just because it yields a lower inflation rate for the present could compromise the credibility of monetary policy. If the domestic real estate market develops as the markets in the US and elsewhere have done in the past year, the contribution of owner-occupied housing prices to headline inflation might become negative later on. And once that happens, it is quite probable that the voices demanding the exclusion of the housing component will be silenced.

*Is monetary policy headed down a dead-end road?*

Another common refrain is that monetary policy is held hostage by the risk of the flight of short-term capital, which has poured into Iceland due to the wide interest rate differential, as soon as the Central Bank lowers the policy rate. Hence the Bank may need to maintain high interest rates indefinitely. There is no reason to make light of the fact that, for the short term, the need to fund the enormous current account deficit limits the Central Bank's scope for reducing the policy rate. Therefore, the Bank must proceed with caution until domestic demand has contracted sufficiently and the foreign trade deficit approaches a sustainable level. This will reduce the need for short-term capital to fund the deficit, thereby reducing the likelihood that the easing of monetary policy will trigger an abrupt exchange rate depreciation. In addition, the output gap is forecast to diminish and turn negative over the medium term and labour market tensions to subside. This will dampen the inflationary impact of a drop in the exchange rate. Therefore, the Central

Bank will hardly be held hostage unless other authorities seek to prevent the normal cooling of the economy. That cooling is not taking place at the moment, however – quite the contrary. So it is astonishing to hear – when underlying inflation is at nearly 7% and the labour market as tight as ever – that this is a golden opportunity to lower interest rates. The time will be ripe when the economy has settled down, and not before.

#### *Broader goals for the Central Bank?*

Those who find fault with the Central Bank's so-called "high interest rate policy" maintain that it's not enough for the Bank to focus on inflation alone. Exactly what is meant by this, or what alternatives are being proposed, is not always clear. It appears though as the critics would like the Central Bank to consider criteria such as competitive position (real exchange rate), employment levels, etc., even though that may sometimes mean higher inflation. The most preposterous idea that has been aired is the suggestion that a ceiling be placed on the Central Bank's policy rate. A restriction of that sort would drastically curtail the Bank's independence and could easily lead to negative real policy rate. This would undermine confidence in the króna and immediately raise inflation expectations. It is of the utmost importance that the public realise that this is actually asking for a return to the arrangements that prevailed in the 1970s and 1980s – and generated three-digit inflation. This is a policy all developed nations abandoned, based on the experience of the high-inflation years of the 1970s and 1980s. Formally or informally, they have made low, stable inflation the primary objective of the monetary policy of an independent central bank. A large number of developing countries have also increased the independence of their central banks, and to good effect. The exceptions are hardly desirable role models – unless Iceland wants to join the ranks of countries like Zimbabwe and Venezuela.

Price stability is a long-term investment. The benefits emerge over a long period of time, and sometimes the price must be paid in advance. This is why it is important that monetary decisions be made by an institution that has a clearly defined mandate to work for the long-term benefits of the public and has the strength to withstand pressure from special interest groups and politicians who may have short-term interests to protect. Confidence in the currency rests on this foundation. Any attempt to undermine the independence of the Central Bank could corrode that confidence, with unforeseeable consequences.

#### *Alleged impotence of monetary policy*

As is stated above, central banks basically have only one tool at their disposal; therefore, it is critical that this tool be as effective as possible. Among potential measures to enhance the effectiveness of monetary policy would be to promote a deeper bond market through more active issuance of Treasury bonds, even at times when the Treasury is not in need of funds. It would also be desirable to issue housing bonds with shorter maturities than has recently been the case.

There are no easy solutions to all the problems monetary policy faces. It is widely argued that globalisation has diminished the impact of monetary policy in individual countries. But what has set the discussion in Iceland apart is the tendency to exaggerate. Some

critics of the Central Bank assert that the Bank's monetary policy is virtually impotent. It is difficult to see how such an assertion fits with the argument that the policy rate is far too high – because one can argue that the destructive power of completely impotent monetary policy must be limited – but let's leave that subject alone. A virtually ineffective monetary policy would, of course, be an extremely grave matter. A logical response to it would be to abandon an independent currency and independent monetary policy, and not to assign monetary policy a wider range of objectives or to fulminate about the Central Bank, whose statutory role is to work toward the achievement of the objective set for it. But to argue that monetary policy is almost totally impotent is a gross exaggeration.

*Is it possible to minimise adverse side effects?*

Globalisation may have reduced the impact of domestic monetary policy and increased uncertainty of its transmission. But the effects of globalisation are not easy to distinguish from the impact of a transitory glut of global savings that temporarily made liquidity abnormally abundant and held interest rates at very low levels. If the interest rate channel of monetary policy transmission is weakened, at least temporarily, this can certainly generate adverse side effects, including increased exchange rate volatility of the króna. How can these adverse side effects be minimised? It would be possible, of course, to intervene in the currency market in order to smooth out exchange rate fluctuations, as the Reserve Bank of New Zealand (RBNZ) did recently. The experience of the RBNZ and the Central Bank of Iceland (for example, in 2001) indicates, however, that the impact of such intervention is most often negligible. In addition, it could work contrary to the inflation target in some instances. Thus there is little else that the Central Bank can do except to work steadfastly toward the attainment of the inflation target. If the Bank is successful, the króna is likely to become less volatile than has been the case recently, because of the close connection between inflation and the exchange rate. Further attempts to reduce exchange rate volatility must, to a large extent, come from others than the Central Bank. Economic policy – not only fiscal policy – that aims at maintaining stability could contribute to a more stable exchange rate and minimise other adverse side effects. To engage simultaneously in massive development projects, a revolutionising of the financial system, and tax cuts, for example, is not conducive to a stable currency or a low inflation rate.

*Future monetary policy arrangements*

Independent monetary policy and a floating exchange rate in a country as small as Iceland can be viewed as an experiment in economics. That experiment is not complete, and it would be premature to come to any firm conclusions about it at this point. It is crucial that the government, interest groups, and the public realise that, for the near term, there is no other choice than to work toward stability within the framework that was set in 2001. Without a tight monetary stance, Iceland would be teetering on the brink of hyperinflation.

To revert to a fixed exchange rate policy would be foolhardy in the extreme, especially given the present unstable situation. It must not be forgotten that when the inflation target was adopted, it was done precisely because the stable exchange rate policy that had

reigned for a decade had become unsustainable, as Iceland stood on the threshold of a currency crisis. It can be argued that in 1995, after Iceland became a member of the European Economic Area and restrictions on movement of capital were finally lifted, two options were forced on EEA member states: to increase exchange rate flexibility and anchor monetary policy by means other than a fixed exchange rate, as Norway, Iceland, and Sweden chose to do, or to seek complete monetary integration, either through EMU membership, which was open only to EU member states, or through a currency board. Only Denmark has been successful in maintaining a conventional fixed exchange rate policy, but it does so within the framework of the European Exchange Rate Mechanism, ERM II. The Danes' success is based on economic stability and confidence that have been earned the hard way over a quarter of a century, with the European Central Bank as a backstop. Building up such confidence can require substantial sacrifice. I doubt that the necessary political support to run such a policy successfully exists in Iceland. The same applies to a currency board.

Therefore, the available options appear, as before, to be a floating exchange rate and an inflation target, or complete monetary integration with Europe. It is normal that these two possibilities be under constant discussion in Iceland, particularly in view of the small size of the economy and the frequency of external demand and supply shocks. But the discussion of this topic as well has been peculiarly incoherent. Various people have maintained that spontaneous adoption of the euro is imminent. This is farfetched. Nowhere has dollarisation – or euroisation – prevailed except in places where hyperinflation has become entrenched, or through government intercession. The Icelandic government could obviously make a unilateral decision to adopt the euro, as some would prefer. But as far as that option is concerned, there is often confusion between what is technically possible and what is economically sensible. The problem with adopting the euro unilaterally is that it is not possible to take a stand on whether such a decision is economically sensible without simultaneously considering EU membership. This is because the unilateral adoption of the euro would cost the nation approximately 16 billion krónas to start with, as it would be necessary purchase coins and bills instead of exchanging them for krónas; in addition, seigniorage would revert to the EU permanently, and considerable uncertainty would arise concerning the position of Iceland's financial system. The value of bills and coins is perhaps not a huge expenditure in a long-term context if EU membership has been ruled out for a long time – but then the government must discuss whether it wants to rule out membership permanently. No political party has done this to my knowledge. Membership in the European Union is not just a monetary question, however, but rather a decision that involves the long-term economic, political, and security interests of the nation. No Icelandic government to date has made it a priority.

*More balanced and logical debate, please!*

Everything leads to the same conclusion: as long as EU membership is not on the agenda, it remains the Central Bank's task to determine the policy interest rate in terms of the inflation target that was adopted in 2001. No credible alternative is available. Thus the Bank must bend all its efforts toward ensuring that it carries out this task as successfully as possible. With the help of the government, the labour market, and other institutions,

the adverse side effects of a heavily burdened monetary policy can be alleviated. Discussions of ways to enhance the effectiveness of monetary policy are welcome. But if those discussions are to generate results, it would be helpful if the arguments were more balanced, more logical, and less prone to exaggeration than has been the case so far. If the Icelandic government chooses to consider EU membership in the future, the advantages and disadvantages of monetary integration will be a fundamental part of a hopefully cogent, composed and balanced discussion of that momentous decision.