A turning point

Már Gudmundsson, Governor of the Central Bank of Iceland
Chamber of Commerce Monetary Policy Meeting, Hilton Reykjavík Nordica, 8 November 2018

Mr. 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.

The economy is now at a turning point, with a strong upswing and below-target inflation giving way to weaker growth and increased inflationary pressures.

Underpinning the progress of the past few years were, on the one hand, a vast improvement in external conditions, which could be seen most clearly in improved terms of trade and a surge in the number of tourists visiting the country, on the one hand, and on the other, in economic policy that proved successful in historical context, keeping inflation under control and ensuring that the exchange rate of the króna was a shock absorber rather than a shock amplifier, as has sometimes occurred in the past.

Monetary policy was successful in bringing inflation — and thereafter, inflation expectations — back to the target after 2012, without sacrifice costs in terms of employment. Foreign exchange market intervention and capital controls, followed by the special reserve requirement on capital inflows into the bond market and high-yielding deposits, insulated the exchange rate from the effects of volatile capital movements, allowing it to develop relatively unhindered and in line with underlying economic conditions. The advantages of a flexible exchange rate therefore prevailed, while the disadvantages were mitigated.

This did not make for an uneventful journey, however, because even though the equilibrium exchange rate had clearly risen, it is always subject to considerable uncertainty at any given time, and the risk of overshooting was genuine. This risk may have materialised to some degree, but had the above-mentioned policy instruments not been applied, it would have materialised much more strongly, with the associated risk of an abrupt correction later on, which could have had adverse consequences for economic and financial stability.

This economic turning point stems from a turnaround in some of the factors that contributed to the upswing. The global economic situation is not as favourable to us. Terms of trade are deteriorating and not improving. The rise in tourist visits to Iceland has slowed markedly. Therefore, as compared with the last three years, growth in export revenues will ease considerably this year and in the years to come. GDP growth will be lower, as will the rise in our real income as a nation, no matter what we may decide about nominal pay increases in wage negotiations or about how we distribute such increases. This also means that the equilibrium exchange rate of the króna has probably fallen in the recent past, which in turn may partially explain the recent depreciation of the króna.

The deterioration in external conditions is not good news, of course, but we must place it in the context of the substantial improvement that has taken place in recent years. On the whole, however, this turning point is positive in a number of ways. The growth rate of the past few years was unsustainable, and it tested the capacity limits of the domestic economy.

According to the Central Bank forecast published yesterday, the landing will be a soft one. GDP growth will measure 2.6% over the next three years, close to the average level that will allow the economy to grow without importing labour. The positive output gap will narrow gradually and close by the end of the forecast horizon, which is in 2021. There will be virtually full employment for the entire period, and purchasing power will continue to rise. Inflation will rise above the target in 2019 but then remain close to the target for the rest of the forecast horizon, partly because the forecast assumes that interest rates will rise when inflation does.

Some observers might say that this is too good to be true. It could turn out that way, of course, but that would be because known or unknown risks not included in the forecast had materialised.

There are so many things that could happen in this regard. There could be economic policy mistakes; for instance, if the Central Bank's real rate declines more than is justified by fundamentals, or if fiscal policy provides a similar stimulus. Were this to happen, the output gap would remain open longer and inflation would be higher. The correction, when it came, would be steeper, and the adverse impact on GDP growth would be more pronounced.

The markets could undershoot or overshoot, derailing the economy at least temporarily. External shocks could strike as a result of trade disputes or further increases in oil prices, and indeed, the alternative scenario in the most recent *Monetary Bulletin* includes just such factors. Wage negotiations could result in broad-based pay rises far larger than the already sizeable ones provided for in the Bank's forecast. The inflation outlook would then deteriorate, which would call for interest rate hikes. GDP growth would weaken as a result, perhaps even ending in a contraction.

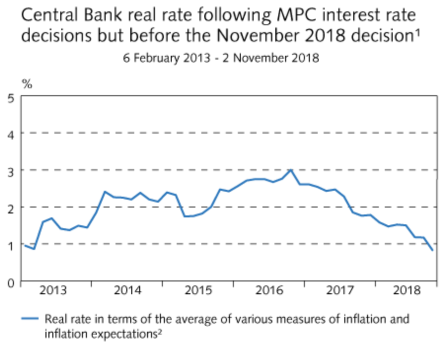
But there is always some uncertainty in both directions, and naturally, we could end up on the receiving end of positive shocks that improve the situation. But under these conditions, it is likely that the risk to GDP growth is tilted to the downside.

In this connection, it is important to remember that we have seldom, if ever, been as well prepared for adverse shocks as we are now. Our external assets exceed our external liabilities. Our international reserves are close to an all-time high and are almost entirely financed domestically. Public and private sector debt has fallen steeply relative to income in the past few years. Our banks are robust, with high capital ratios and abundant liquidity, and the Central Bank's newly published stress test indicates that they can withstand much more severe shocks than we currently consider likely. Unlike many other advanced countries, we have considerable scope for economic policy to respond to shocks, as Central Bank interest rates are well above zero and the government is operating at a surplus and is relatively well positioned with regard to debt. The exchange rate of the króna is still strong, although it has fallen in the recent term, and the real exchange rate is estimated to be broadly as it was in late summer 2016.

All in all, it can be said that our position is still relatively good, and nothing has yet happened to give cause for deep-seated pessimism.

Yesterday the Bank announced a 0.25% increase in its key interest rate, to 4.5%. This rate hike was decided in view of economic developments and prospects, including those described in the Bank's new forecast, and in view of the considerable decline in the Bank's real rate in recent months, which stems from rising inflation and inflation expectations. One of the factors the Monetary Policy Committee considers when it assesses the monetary stance is the Central Bank's real rate in terms of various measures of inflation and inflation expectations. This is illustrated in Chart 1, which shows that the real rate was 0.8% just before the last interest rate decision. This is lower than in 2013, when there was still a considerable slack in the economy. Of course, the progress made in anchoring long-term inflation expectations at the target — another term for enhancing the credibility of monetary policy — has made it possible, all else being equal, to keep inflation at target over the medium term at lower interest rates than would otherwise be required. But it is questionable whether a real rate of less than 1% will suffice for an economy at or above full employment, with inflation already above the target, with a positive output gap, and with GDP growth that is approaching equilibrium from above.

<u>Chart 1</u>



1. Until 21 May 2014, the Bank's key rate is based on the average of deposit rates and the maximum rate on 28-day certificates of deposit. From then onwards, the key rate is the rate on seven-day term deposits. 2. Until February 2012, the real rate is based on twelve-month inflation, one-year corporate inflation expectations, one-year household inflation expectations, the one-year breakeven inflation rate in the financial market, and the Central Bank forecast of twelve-month inflation four quarters ahead. From March 2012 onwards, it is also based on market agents' one-year inflation expectations according to the Central Bank's quarterly survey.
Sources: Gallup, Statistics Iceland, Central Bank of Iceland.

It cannot be said that the interest rate hike took the market by surprise. According to the Bank's survey of market agents' expectations, published on Monday, most respondents expected a 0.25 rate increase before the end of the year. The share of respondents who considered the monetary stance too loose had risen steeply since August, reaching 40%. And bond market activity in the wake of the rate hike did not indicate that the increase was unexpected.

Even so, the rate hike has been criticised by some of the social partners and some politicians. This suggests that the Monetary Policy Committee did not explain well enough that sometimes it is better to raise rates now so as to avoid a much larger rate increase later on. In view of this criticism, I think it appropriate to explain this more fully.

In general, Central Bank attempts to keep interest rates as low as possible — but as high as necessary — at any given time. What that optimum level is, however, depends on conditions, and it changes from one time to another. If Central Bank rates deviate from this optimum, the public will bear the expense. If they are higher than need be, inflation could fall below target and GDP growth would be weaker than it might be otherwise. If they are lower than need be, inflation could get out of hand and economic instability could take root. In that case, a much larger rate hike would be needed later on. So interest rates that are too high or too low do not come without costs to the general public.

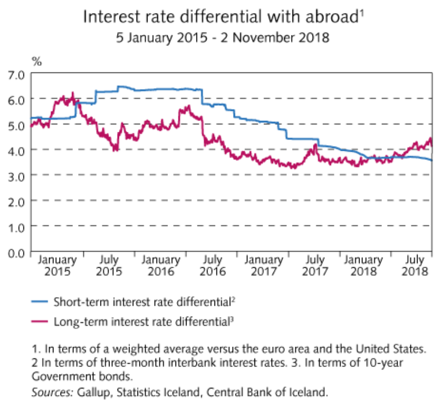
In this instance, it should not be forgotten that household mortgages tend to be long-term loans, and a majority of them are indexed to the CPI. If inflation is kept at target over the long term, these mortgage rates will be lower in the long run than they would be otherwise, even though an increase in short-term central bank rates might sometimes be required. A rate hike in the present that is consistent with current conditions contributes to lower interest rates further ahead. Sometimes this happens very quickly — for instance, short-term central bank rates rise, causing longer-term rates to fall because the rate hike results immediately in lower inflation expectations. There are a number of examples where a rise in central bank rates leads to lower long-term rates rather quickly.

In the speech I gave here two years ago, I showed that real interest rates have fallen steeply in the past two decades, both in Iceland and internationally. I pointed out that the longer inflation expectations remain at target, the longer the propensity to save remains high, the more domestic debt levels fall, and the longer we have a positive net external position, the longer this trend could continue in Iceland. That still applies today.

Last Friday, the Bank announced a reduction in the special reserve requirement (SRR) on capital inflows into the bond market and into high-yielding deposits, which was imposed in June 2016. The SRR was lowered because the interest rate differential with abroad has narrowed and the exchange rate of the króna has fallen. This was fully in accord with repeated statements by the Bank; i.e., that the premises for lowering the SRR would grow stronger, other things being equal, as the interest rate spread narrowed and the exchange rate fell.

When the SRR was introduced in June 2016, capital flows into the bond market had more or less clogged up the interest rate channel of monetary policy transmission. As a result, the effects surfaced primarily in a higher exchange rate. Because capital controls on outflows had not yet been lifted at that time, the risk existed of an overshooting of the exchange rate, with adverse repercussions for Iceland's tradable sector. In addition, it was considered unfortunate, and actually unnatural, that large carry trade positions should accumulate before those that had entered the economy before the crash had been released. The exchange rate of the króna was also rising, and rose even further thereafter, because of strong tourism-generated inflows through the current account. This, of course, had a crowding-out effect on other segments of the tradable sector. If this had been compounded by a steep rise in carry trade-related inflows, Iceland would have found itself in a more dangerous position, with increased risk of an abrupt correction later on and the associated impact on economic and financial stability. Because of the recent decline in the exchange rate, this risk has receded, and it could even be argued that the risk is currently in the other direction; i.e., that excessive pessimism and self-fulfilled expectations of a further depreciation in the króna could lead to undershooting.

Chart 2



The interest rate differential is still wide, however, as can be seen in Chart 2, particularly the long-term differential, which has only narrowed by 1 percentage point (and much less, if adjustments are made for CDS spreads). It would therefore have been imprudent to lower the SRR to zero now, and furthermore, there is limited experience of the impact of adjustments in capital flow management tools of this type.

However, this does not change the fact that the objective is to keep the SRR at zero whenever possible. We have said that this tool should be our third line of defence, after conventional economic policy (including intervention in the foreign exchange market) and conventional macroprudential tools. This is not to say that the SRR is some sort of emergency device, as distressed economies hardly need worry about excessive voluntary capital inflows.

The capital flow management tool, or CFM, is not a capital control in the sense that it restricts or halts certain capital flows explicitly, as was the case during the tenure of the comphrehensive capital controls on outflows. It changes the incentives for inflows — the shorter the investment horizon, the stronger the impact. But this brings some costs with it, in terms of Iceland’s image and the effectiveness of its markets, and it would be better to do without the SRR if possible.

This prioritisation of policy tools is consistent with the position taken by the International Monetary Fund (IMF). The IMF has been of the view, however, that CFMs of this type should not be applied pre-emptively. This position has not been adequately argued, in my opinion. In this context, it should be borne in mind that the Fund’s advice to Iceland on CFMs is based on a compromise by the IMF Executive Board in connection with the Fund’s Institutional View (IV) on this topic. This compromise was difficult and is perhaps somewhat fragile, and therefore, the text of the IV may not be deviated from to any marked degree.

When the report from IMF staff was discussed by the Executive Board last year, however, Iceland received considerable support with the application of the CFM. Presumably, many saw that the CFM was not being substituted for appropriate conventional economic policy (which the IV recommends against) but the reverse: it was being used to make conventional economic policy possible.

The IMF does not have jurisdiction in this matter in Iceland; it can only advise. That is not the case with the EEA and the OECD, where we still have a special exemption from unrestricted movement of capital, and the question of whether those institutions would view the CFM as a macroprudential tool or a capital account restriction has not yet been put to the test.

The bottom line in all of this is that here in Iceland, we need to formulate an independent position on this matter, based on in-depth analysis and our own interests. In addition, these issues are garnering considerable attention internationally at present, including in the wake of a report by the Eminent Persons Group, requested by the G20 and presented in October 2018. In that report, it is recommended that the IMF revisit the IV and make it more flexible as regards CFMs like that currently in use in Iceland.

Honoured guests: I had not originally intended to speak at such length on economic developments and prospects and monetary policy conduct, but public discourse over the past few days changed that.

I also intended to discuss other changes that, in the long run, could be much more important than whether interest rates are currently a few basis points higher or lower. These changes fall into two categories. First are the changes that could take place following the Ministerial Committee's decision this autumn to commence work to improve the interactions between monetary policy and financial stability policy and to strengthen the framework and architecture of macroprudential policy and financial supervision. Second are the changes in payment intermediation caused by technological advances, among other factors — which, for example, have put the question of a possible electronic króna, or rafkróna, on the agenda. I have high hopes for these changes. But discussions of them must await another occasion.