



Central Bank of Iceland

Small, open and financially integrated economies (SOFIEs) and the IMFS

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Beyond Monetary Policy

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Outline



- Two perspectives on the global economy and the IMFS
- Global financial integration and the interaction of monetary policy and financial stability in SOFIEs
- The individual country response
- Reforms to the IMFS

Two perspectives



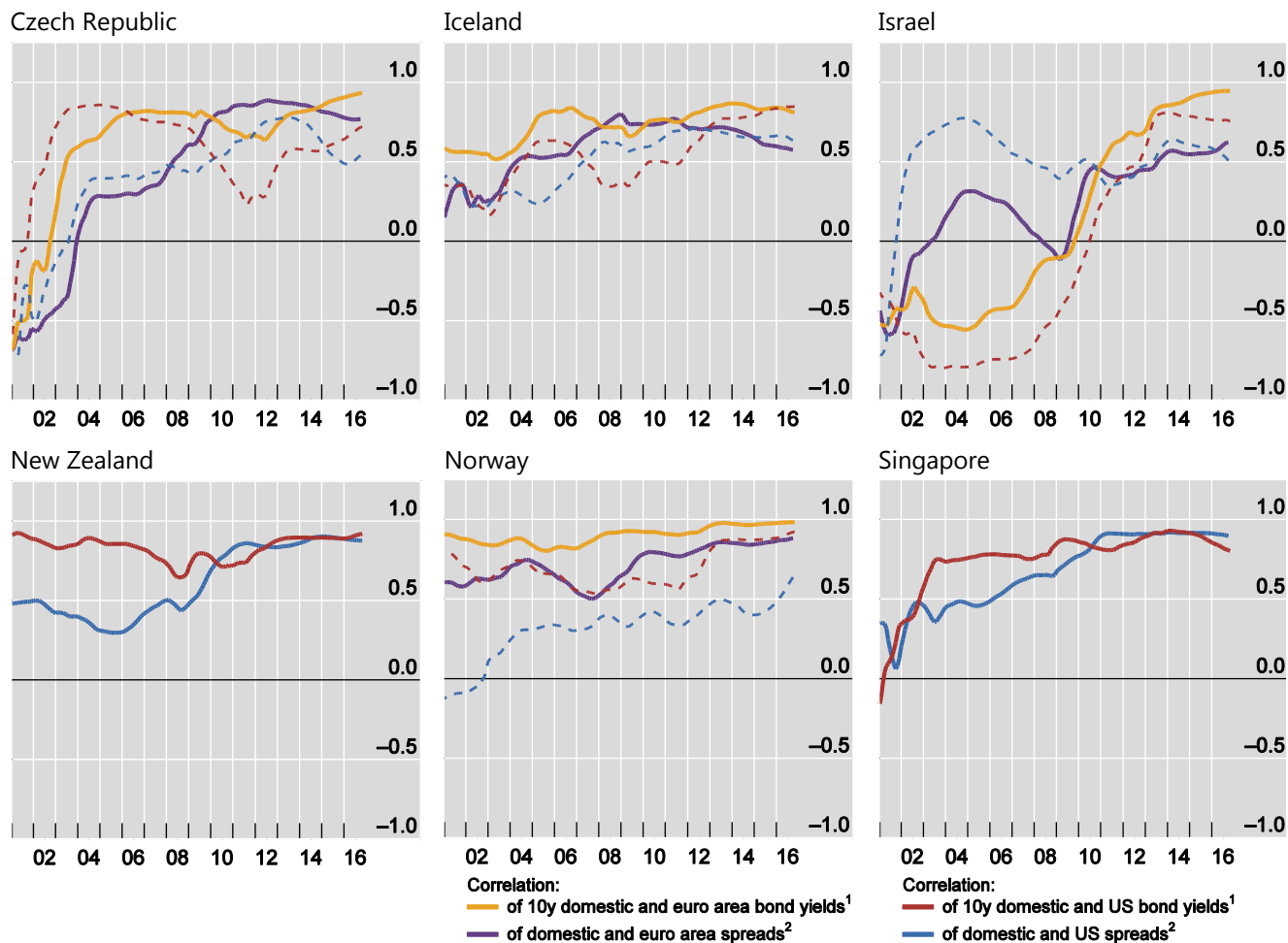
- Global current account imbalances – asymmetric adjustment – keeping your house in order – official arrangements: lending to sovereigns of debtor countries to facilitate balance and payments adjustment
- Global financial integration – financial imbalances – spill-overs and feedbacks – keeping your house in order is necessary but not sufficient – liquidity provision to internationally active banks – CB swaps
- Not mutually exclusive
- Official arrangements such as IMF facilities are lagging in the second perspective

Global financial integration and SOFIEs: theory

- Taking global financial integration to its economic extreme and assuming constant risk premia =>
- Long term rates in SOFIEs become determined by monetary policy in the big countries (core rate-setters)
- Inflation targets can still be reached through the exchange rate channel
- If exchange rates are “well behaved” and the financial sector sufficiently regulated and supervised =>
- A floating exchange rate and “keeping your own house in order” is sufficient for independent monetary policy and financial stability

Evolving correlations between SOE and US/euro area sovereign yields

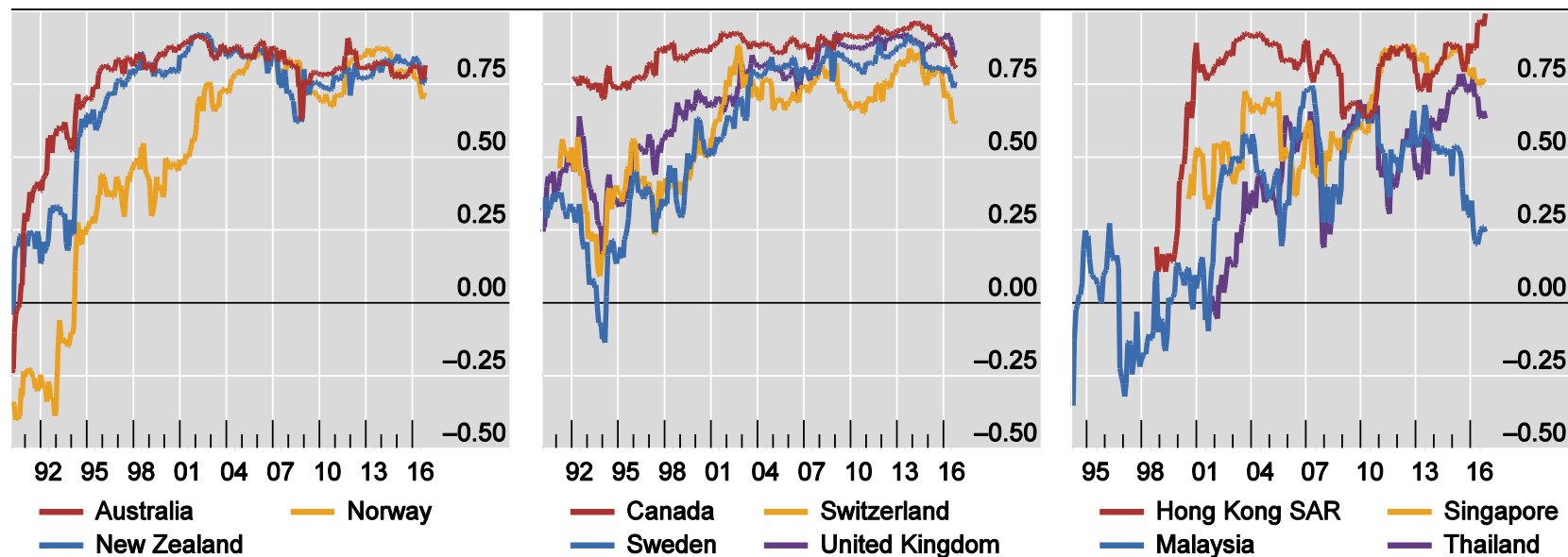
10-year rolling correlations, average monthly yields



¹ Rolling correlations between the domestic SOE and US 10-year government bond yields. For European countries, also with euro area 10-year government bond yields. ² Rolling correlation between the domestic SOE and the US and euro area short- and long-term sovereign spreads. The short-term interest rate is a 3-month market rate and the long-term yield is a 10-year government bond yield.

Correlation between domestic and US long-term yields¹

Graph Number



¹ Monthly changes using a 36-month moving window; for Hong Kong SAR, Malaysia, Singapore and Thailand, 24-month moving window. Ten-year bond yields.

Sources= Bloomberg; national data.

Global financial integration and SOFIEs: empirics



- Data on long-term rates and spreads consistent with the story (and lot of other empirical work as well) – we are still some way from the theoretical limiting case
- But:
- Exchange rates do not smoothly reflect fundamentals: UIP does not hold except in the long run and then with sharp and disorderly corrections – carry trade
- Volatile capital flows driven by push factors (global financial conditions)
- Interaction with financial vulnerabilities, e.g. domestic currency mismatches and international activities subject to regulatory gaps of domestically headquartered banks

Global financial integration and SOFIEs: conclusions

- A floating exchange rate is not sufficient for “safe” monetary policy independence
- It is becoming increasingly difficult for SOFIEs to conduct independent monetary policies without creating risks to financial stability
- Keeping your own house in order is not sufficient

What can countries do on their own?



- Give up on independent monetary policy:
 - Monetary union
 - Fixed exchange rate
 - Interest rate pegged to those of global rate-setters
 - Other policies have to take care of domestic economic stabilisation
 - but will they?
- Increase resilience and ability to live with exchange rate fluctuations (reduce the fear of floating) – regulate FX risk on bank balance sheets, currency mismatches, etc.
- Use more tools, some of which actually decrease the level of financial integration (but hopefully where it matters less for efficiency and growth): FX interventions, “orthodox” macropru and capital flow management: => IT+

Prudential regulations or tools after capital controls in Iceland



	Regulation or tool	Status
a)	LCR and NSFR in FX	Implemented
b)	Restrictions on deposit taking in foreign branches	Partly restricted by a) – future issue
c)	Limits on FX imbalances	In progress
d)	Restrictions on FX lending to unhedged borrowers	Before Parliament
e)	Capital flow management tool for capital inflows	Implemented

What does this mean for reform of the IMFS?



- Review IMF surveillance and facilities and other parts of the GFS in light of the second perspective (begun, e.g. new reports, new facilities (PCL and FCL) and stock-taking of IMS and GFS)
- Reduce financial regulatory flaws and gaps at the global and regional level – capital flows and cross-border banking
- Institutionalisation of CB swaps?
- Accommodate but monitor SOFIEs' unilateral use of additional tools (CFM tools in particular)
- Rules of the game?

