4 November 2011

# Monetary policy

Már Guðmundsson, Governor. Speech at a breakfast meeting of the Iceland Chamber of Commerce, 4 November 2011

The Iceland Chamber of Commerce has a long-standing tradition of holding a breakfast meeting like this one on economic developments and prospects and monetary policy, following the publication of the Central Bank's autumn forecast. As before, I would like to thank the Chamber of Commerce for this initiative, as there is a great need for informed discourse on monetary matters.

In my speech a year ago, I discussed the progress made in stabilising the economy as is evidenced by the underlying current account surplus, the stable and subsequently strengthening currency, and inflation that was rapidly approaching the Central Bank's inflation target. I mentioned, however, that robust recovery had not yet taken hold. It seemed to me then that the recovery had begun, and this has since been corroborated. At that time, GDP was projected to grow by just over 2% in 2011 – which was not considered terribly strong in view of the slack in the economy. I was concerned as well about the low level of investment and the prospect of weak export growth in spite of a very low real exchange rate. The inflation outlook seemed much better, though, due to a rising exchange rate and the slack in the economy. Therefore, it was forecast that inflation would fall below 2% as 2011 progressed and then rise back to target by the end of 2013. As always, it was emphasised that the outlook was uncertain – which indeed proved to be the case.

So where do we stand now, a year later? I think the big picture is this: economic recovery has materialised, while stability has proven more elusive.

GDP growth this year will be slightly over 3%, which is above the forecasts from a year ago, largely due to changes in inventories and a smaller-than-forecasted contraction in public consumption. GDP growth is projected at 2½% annually for the next three years. I wouldn't be surprised if it proves higher for 2011, once final figures are in a few years from now. The most recent *Monetary Bulletin* contains a discussion of forecasts and forecasting errors, which shows that final figures on investment and GDP growth tend to lie above the first figures.

Employment has been increasing, and unemployment has fallen. It is cause for relief that the Directorate of Labour's analysis indicates that most people leaving the unemployment register at present are going back to work. On the other hand, my concerns from last year concerning the low investment level and relatively weak export growth have not disappeared. It is true that business investment excluding energy-intensive industry and ships and aircraft is strengthening and, according to the forecast, will grow by 8% this year, while total business investment as a share of GDP will rise over the forecast horizon, to about 11% in 2014. It will still be below the 30-year average of 12½%, however. On the other hand, exports of goods and services will grow by about 2½% this year and by an average of just under 2% per year in 2012 and 2013. This is not a very cheery prospect, given that the real exchange rate of the króna is currently over 20% below the historical average. It is important to bear in mind that low investment levels and weak export growth are related phenomena. A large share of Iceland's exports (marine products and aluminium) are subject to capacity constraints, and in some instances, increased export levels would require substantial investment. Thus it is important to facilitate investment in export sectors. Those who believe that monetary policy has been a critical factor after the real policy rate fell to the current -1% are mistaken, however. Much more important are risk aversion in the markets, limited access to foreign credit, an uncertain operational environment, and impaired corporate balance sheets.

Chart 1

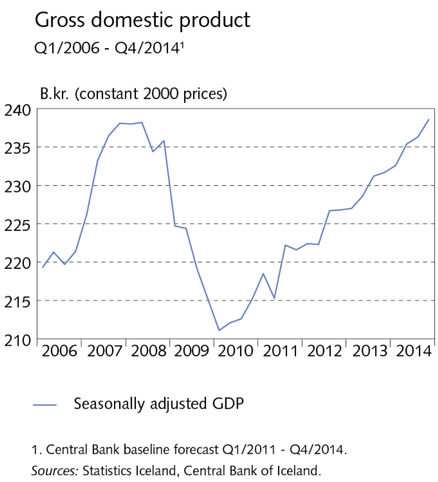



Chart 2

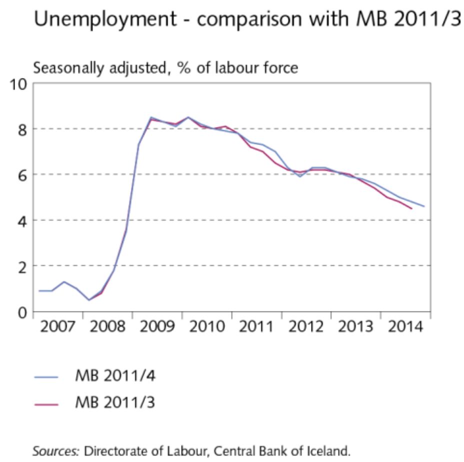



Chart 1 shows, on the one hand, how the economic recovery looks so far and how it compares with the Central Bank's forecast through 2014 and, on the other, developments in unemployment over the same period. According to these data, GDP was similar to Q4/2006 levels in Q3/2011 but will rise back to the peak of the boom years towards the end of the forecast horizon. At the same time, unemployment will decline steadily to 4½% near the end of the forecast horizon, and according to the forecast, the slack in the economy will have vanished by 2014. It is highly uncertain, however, just how much slack exists at this juncture.

But inflation is the big change from the outlook around this time last year. Instead of falling slightly below target and remaining there for some time, inflation has taken quite a jump in 2011. It did fall below target, but it stayed there only three months before taking off again, peaking at 5.7% in September. That figure actually corresponds to over 6% inflation, however, if one takes into account the change in treatment of broadcasting fees earlier in the year. According to the Bank's forecast, inflation will remain at this level until early next year and then begin to taper off. It will be reasonably close to the inflation target around the end of 2012. The inflation target will be fully reached towards the end of 2013, which is broadly in line with last year's forecast. The difference is that the target will be reached from above, and not below.

What caused such a radical change? First of all, there were increases in oil and other commodity prices. Second, the króna depreciated by 6½% in the first half of the year, bottoming out in mid-July before reclaiming about 4% of that loss. Third, house prices rose. Fourth, wages rose far in excess of productivity increases.

Early in the year, it was primarily external – and presumably transitory – factors that caused the spurt in inflation. But as the year progressed, domestic cost pressures played a progressively larger role – wage increases in particular. For example, unit labour costs are expected to increase by 5½% this year and core inflation 3 excluding tax effects was up by 4½% in October, as opposed to just over 1% at the beginning of the year.

Now let us look at monetary policy year-to-date. At the Monetary Policy Committee's first meeting of the year, in February, it was decided to cut the Bank's interest rates by 0.25 percentage points and communicate a neutral bias regarding the future interest rate path. This proved to be the last interest rate cut of the year. What we call the "effective policy rate", which is where the Bank's interest rate spectrum has maximum effect on short-term market rates, was then 3.6%. In 2011, the effective policy rate has been the average of the current account rate and the maximum rate on 28-day certificates of deposit. Interest rates were then held unchanged and the neutral bias was retained at the MPC meetings in March and April. In June, however, the Committee indicated that, other things being equal, it was likelier to raise interest rates than to cut them at upcoming meetings, owing to strong wage increases, marked depreciation of the króna, and rising domestic inflation. Consequently, it should have taken no one by surprise that the MPC should raise interest rates in mid-August, when the Bank's forecast stated that inflation would gain momentum in coming months and the economic recovery would remain on track. And indeed, insightful analysts predicted a rate hike. In September, interest rates were kept unchanged and the positive bias was kept. It was stressed that the decision did not represent a change in policy. A number of observers speculated that it did, though, perhaps motivated by the increasingly uncertain global situation. This is probably why the Committee's decision to raise interest rates in November took the market more by surprise than might have been expected.

Before I explore the November interest rate decision further, I must mention two things. First, while Iceland was engaged in its IMF-supported programme, exchange rate stability was given priority over the determination of interest rates based on the domestic inflation outlook and economic conditions. This is why interest rates were so high in 2009 and in the first half of 2010. On the other hand, as I have previously explained in speeches and papers, it was appropriate that emphasis should shift back to the inflation outlook and the economic slack as the danger of further currency depreciation dissipated and exchange rate-linked loans became less prominent in the balance sheets of Icelandic households and businesses without foreign-denominated income. When the IMF-supported programme concluded at the end of August, monetary policy shifted back to the inflation targeting regime provided for by law and the March 2001 agreement between the Central Bank and the Government.

Second, a considerable body of experience and theoretical study indicates that acceptable monetary policy can roughly be captured with an equation in which the policy rate is determined by the deviation of inflation from target and the output gap. In addition, the nominal interest rate level is determined by the equilibrium real interest rate, which is the real interest rate that is consistent with inflation at target and demand in line with potential output. This is the so-called Taylor rule. But note that I refer to “acceptable” monetary policy. Truly sound monetary policy is always more complex, as it takes account of forecasts of inflation and GDP growth, financial market conditions, and a variety of risk factors. But the Taylor rule is a good test because, other things being equal, the policy rate should be reasonably well in line with it unless there are convincing reasons for a deviation.

With this in mind, let us turn to the November interest rate decision. The Monetary Policy Committee decided to raise interest rates by 0.25 percentage points. That decision, of course, was based on the most recent statistics and the indications in the Bank’s forecast. First of all, inflation is far above target and is forecast to continue rising until early in 2012 before tapering off as the year progresses. Second, available measures of inflation expectations indicate that longer-term expectations are considerably above target. These measures of inflation expectations are flawed, of course – perhaps especially so at this time. Survey measures have a tendency to take excessive account of recent inflation, and bond market measures of inflation expectations are skewed by a variety of market imperfections at present. But flawed though they may be, these are the only measures we have, and it would be irresponsible simply to ignore them. Third, indicators suggest that domestic demand was strong in Q3 in spite of the global situation, and that the economic recovery is strong enough not to be derailed by resistance to inflationary pressures through modest rate interest hikes. Fourth, we have the global situation, which is mainly a risk factor at this juncture and has not yet had a measurable impact on domestic economic developments.

But we did not merely raise interest rates. We also stated that, in view of the economic situation and outlook, the current interest rate level appeared broadly appropriate for the next several months. In other words, significant new developments would be required for the MPC to raise interest rates – or lower them – at upcoming rate-setting meetings. I notice that the bond market seems to have realised the implications of this, as yields at the longer end of the market have not risen since the last interest rate announcement. But looking further ahead, it should be clear to everyone that if GDP growth forecasts materialise in coming years and the slack in the economy disappears, the monetary slack manifested in a negative real policy rate of over 1% must be removed over time.

So where do we stand with respect to the monetary policy stance? Is monetary policy lax or tight? Chart 3 shows the Central Bank's real interest rate measured by the effective policy rate and twelve-month inflation. The chart shows that, in spite of two recent rate hikes, the real interest rate will be lower in Q4/2011 (assuming unchanged interest rates in December) than at any time since the financial crisis struck, with the exception of Q1/2009, when inflation soared up above 18% and a dramatic disinflation episode was in the offing.

Chart 3

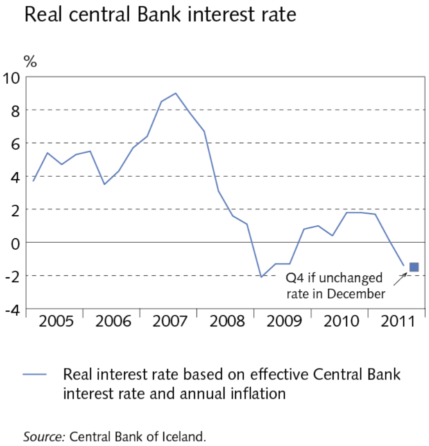
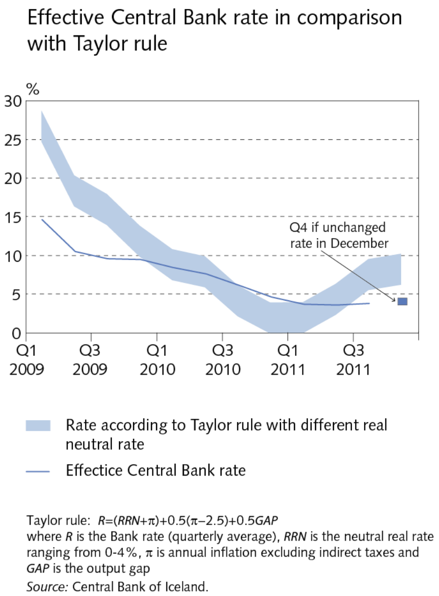



Chart 4

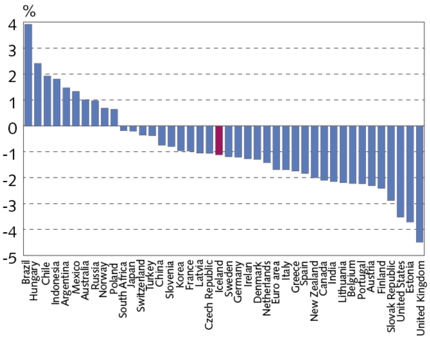



But what about the Taylor rule, shown in Chart 4? There is a significant deviation at the moment – one that perhaps requires some explanation. But there's something wrong. Interest rates are on the wrong side of the argument! They are too low, not too high, even if we assume that the equilibrium real interest rate is zero.

Chart 5

Chart 6

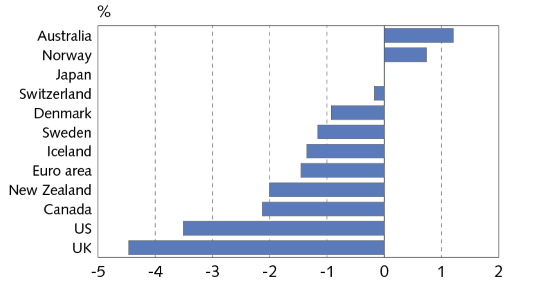
Real policy rate in various countries




*Sources:* Macrobond, Central Bank of Iceland.

Real interest rates in various industrial countries

Effective central bank interest rates less annual inflation[1]



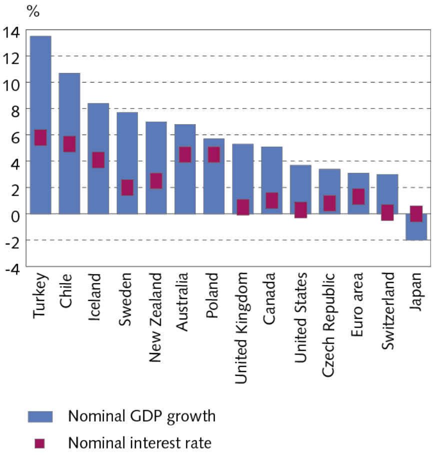

1. Based on average interest rates on deposits and maximum bid rate for 28-day CDs.

*Sources:* Macrobond, Central Bank of Iceland.

Neither does international comparison suggest that Iceland is off the charts. Chart 5 shows a comparison of the real policy rates in a number of countries, based on the most recent interest rate decisions and the most recent twelve-month inflation figures. Iceland is somewhere in the middle. In Chart 6 we see several industrialised countries. Iceland is at about the same level as Sweden. Interest rates are higher in countries that are further along in the business cycle and have less slack, and they are lower in countries where the slack is greater, monetary policy is more credible, and long-term inflation expectations are near target in spite of higher current inflation.

Chart 7

Nominal interest rates and annual nominal GDP growth in various countries[1]

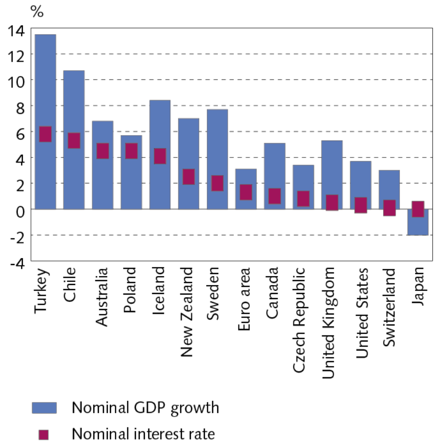



1. IMF and Cental Bank of Iceland forecast for 2011

*Source:* IMF.

Chart 8

Nominal interest rates and annual nominal GDP growth in various countries[1]




1. IMF and Cental Bank of Iceland forecast for 2011

*Source:* IMF.

Finally, I show charts that illustrate, on the one hand, nominal GDP growth as forecasted for 2011 and, on the other, the current nominal policy rate. Some have posited that monetary policy should aim at keeping nominal GDP growth as stable as possible at a level that, in equilibrium, would deliver a desirable inflation target. I have certain doubts about how this would work in practice, but that is beyond the scope of my speech today. But if such a rule were followed, the results would depend on the inflation target and the GDP growth target. If the inflation target is perhaps 2½% and potential output growth in the 2½-3% range, it would be around 5-6%. In Chart 7, we can see that the countries fall into three categories. First are the countries significantly below this level. All of them have relatively low policy rates in accordance with the rule. Then we have the countries that are more or less on the right track and, finally, three countries above that. Iceland is in this last group, and the other two are emerging countries with much more GDP growth potential than developed industrialised economies have. It is interesting to note that Iceland is in third place as regards nominal GDP growth and in fifth place as regards the policy rate.

All of this comparison points in the same direction. It simply cannot be argued that Iceland is out of sync with other countries because of excessive monetary restraint. Quite the contrary: some indicators suggest the reverse.

I know that I am not addressing all possible criticism with these points, but I hope that those listening to me will begin to ponder whether some of that criticism has perhaps been somewhat unbalanced. Some criticism of monetary policy is more pertinent, however, and I would like to address three points.

It has been asked why the Monetary Policy Committee raised interest rates when the Bank has forecast that inflation will subside markedly next year. Does that forecast make the rate hike unnecessary? There are two answers to this. First, the rate hike is a part of the forecast, and if it is not implemented, the forecasted inflation path will no longer be the most likely one. Second, the inflation outlook is uncertain and, in light of current inflation expectations, it would be imprudent not to take action.

It has also been asked whether there is a transmission mechanism in place at present. Do higher interest rates reduce inflation? It is a bit paradoxical to say that interest rates have little impact and then make a terrific fuss about them. Be that as it may, the transmission mechanism is certainly damaged at the moment, and it was somewhat damaged before the crash as well. But there is a transmission mechanism in place. The weight of non-indexed, variable-rate loans has increased. Low deposit rates have fostered a shift towards investment in real estate in the recent term, and some have expedited purchases of consumer durables. Finally, there is some impact on the exchange rate in spite of the capital controls, both because of decisions by owners of offshore krónur on whether they expatriate their interest and because domestic residentsare subject to a repatriation requirement but not a conversion requirement.

It has been asked why we are raising interest rates when there is no economic overheating and investment is at a minimum. It is true that the economy is not overheated, so rate hikes do not have the intention of affecting that. But interest rates do affect inflation even though the current situation does not entail overheating. These effects come through a stronger currency and lower wage drift. Furthermore, it is very common that central banks begin to shift towards a neutral monetary stance by raising nominal interest rates before the slack has disappeared so as to avoid sharper increases later at the tipping point between slack and excess demand. Examples of this are the European Central Bank's rate hike earlier this year and the Swedish Riksbank's increases in mid-2010, when unemployment in Sweden topped 8% and the output slack measured almost 4%. Iceland's output slack is just under 2% this year.

I will conclude my remarks now. I know there are a number of questions I have not answered, and a number of aspects of this complex situation that I have not addressed. My answers to the questions you ask me now may fill in some of the gaps. On the other hand, it is important that we discuss these matters calmly and try to promote the best possible understanding of how monetary policy works, as this will make a genuine contribution to the current discussion of Iceland's future monetary policy regime. It is well to remember, though, that no monetary policy will be successful if the tools it offers are never used to tighten the stance. Naturally, opinion differs on the appropriate monetary stance at any given time, as uncertainty is a permanent feature of economic life – not only uncertainty about the future, but also about the present and the recent past.