Central Bank of Iceland

Monetary policy in Iceland

Már Guðmundsson
Governor, Central Bank of Iceland

Danske Bank
Copenhagen, 20 June 2012

Preamble

History of exchange rate regimes and monetary policy frameworks in Iceland

1873-1914	Nordic currency union and gold standard.
1914-1922	Hard peg to the Danish krona.
1922-1925	Floating exchange rate with Pound Sterling as a reference currency.
1925-1939	Peg against Pound Sterling. Capital controls and protectionism.
1947-1970	Adjustable peg within Bretton Woods. Capital controls but trade liberalisation in the early 1960s.
1970-1989	Adjustable peg developing during periods into managed float. USD dollar a reference and later a trade weighted basket.
1990-2001	Harder peg during the first half, punctuated by two devaluations. More flexible exchange rate targeting introduced in the latter half in the wake of lifting capital controls.
2001-2008	Inflation targeting and a floating exchange rate.
2008-	Variable hybrid of exchange rate and inflation targeting supported by capital controls. IT gaines ground as the currency crisis abates and domestic balance sheets are shifted to domestic currency.

The recent Icelandic saga

Two separate but interrelated sub-stories:

1. Iceland’s boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies.
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European “passport”).

The two converged in a tragic grand finale in early October 2008, when Iceland’s three commercial banks failed and were placed in special resolution regimes.

Inflation targeting and the build-up to the crisis

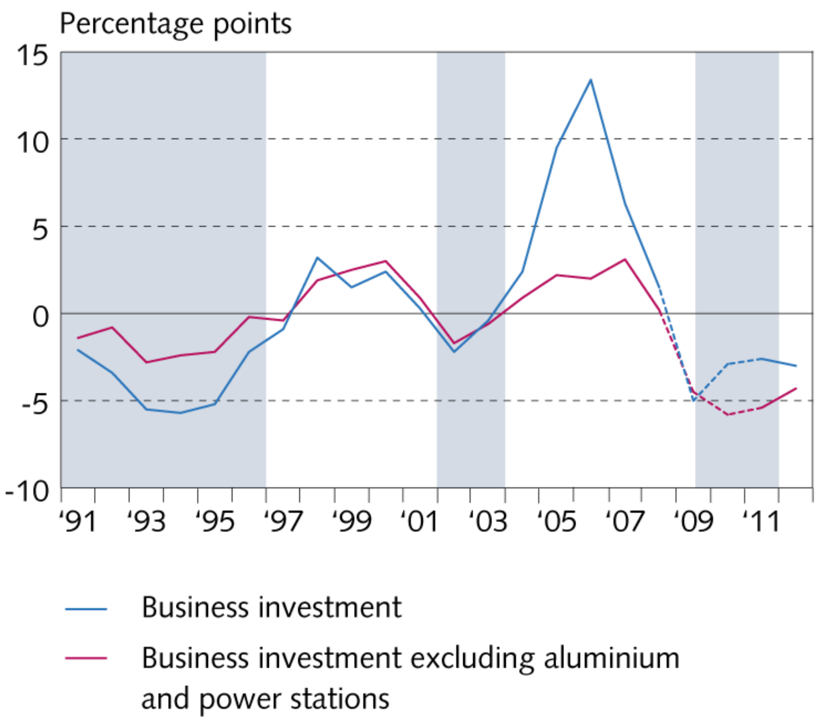
Inflation targeting from 2001

- Exchange rate targeting got more and more difficult to manage as Iceland became more financially integrated with the rest of the world after becoming member of the EEA
- IT adopted in March 2001 (target of 2½%)
- CBI granted instrument independence
- Bank supervision taken out of the CB in the late 1990s and an integrated FSA established
- The framework was put to a test from 2004 onwards

Positive investment shock, followed by overheating

Business investment as % of GDP 1991-2012[1]

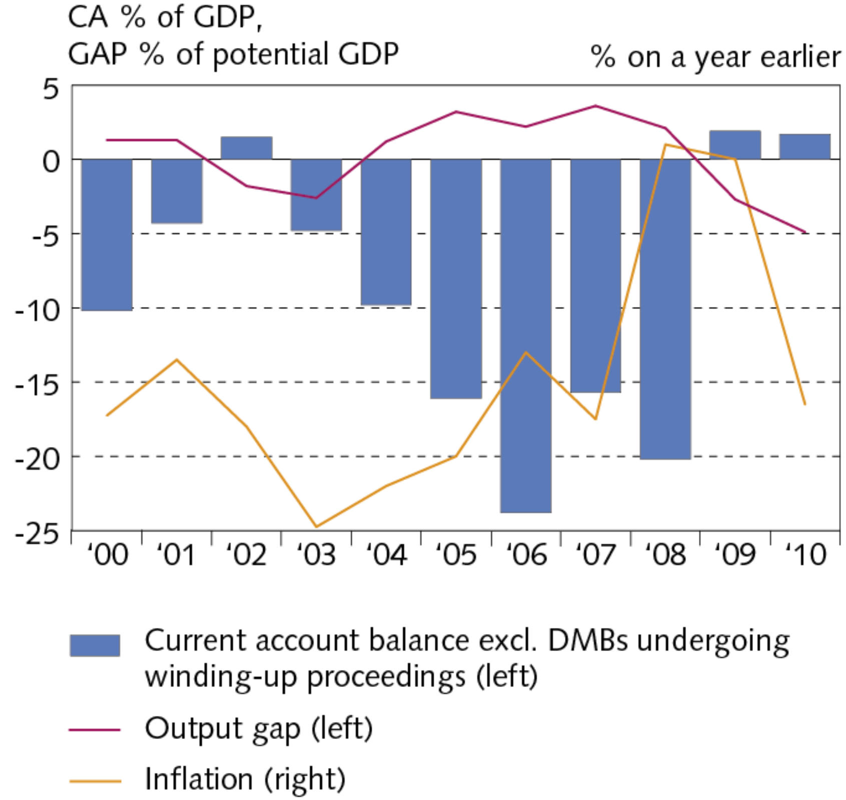
Deviation from average for 1970-2007



1. Central Bank baseline forecast 2009-2012. Shaded areas show periods with negative output gap.

Sources: Statistics Iceland, Central Bank of Iceland.

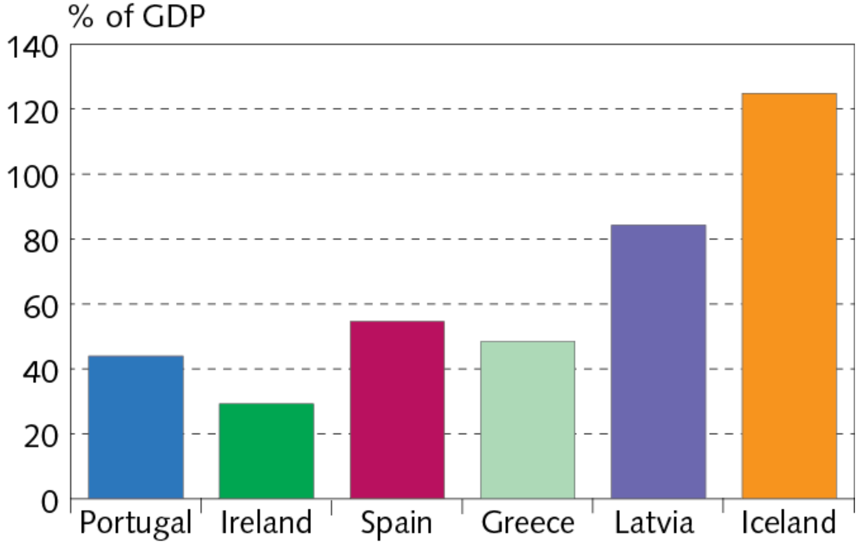
Current account, output gap and inflation



Sources: Statistics Iceland, Central Bank of Iceland.

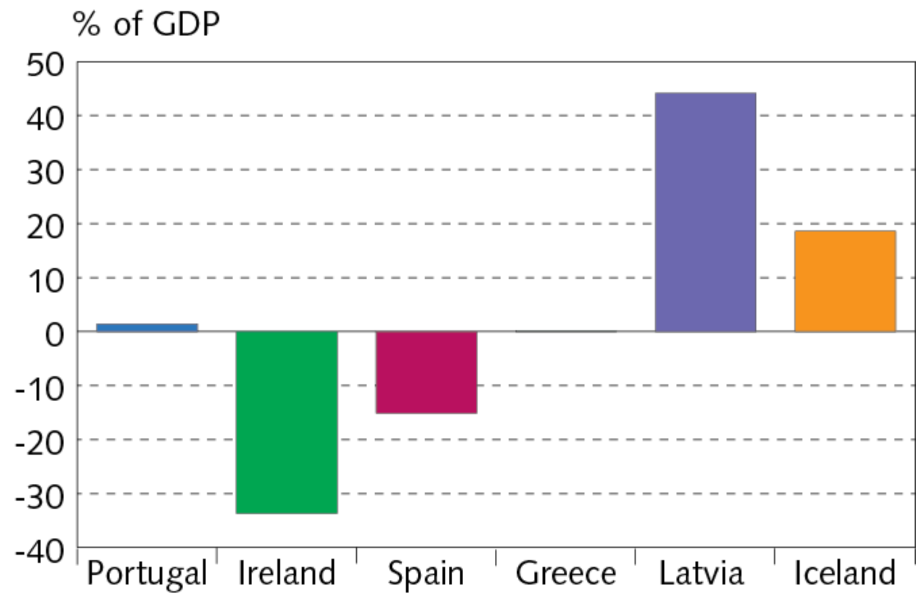
Fuelled by strong capital inflows

Net private capital inflows excluding FDI, cumulative 2002 - 2008



Sources: Various Central Bank websites.

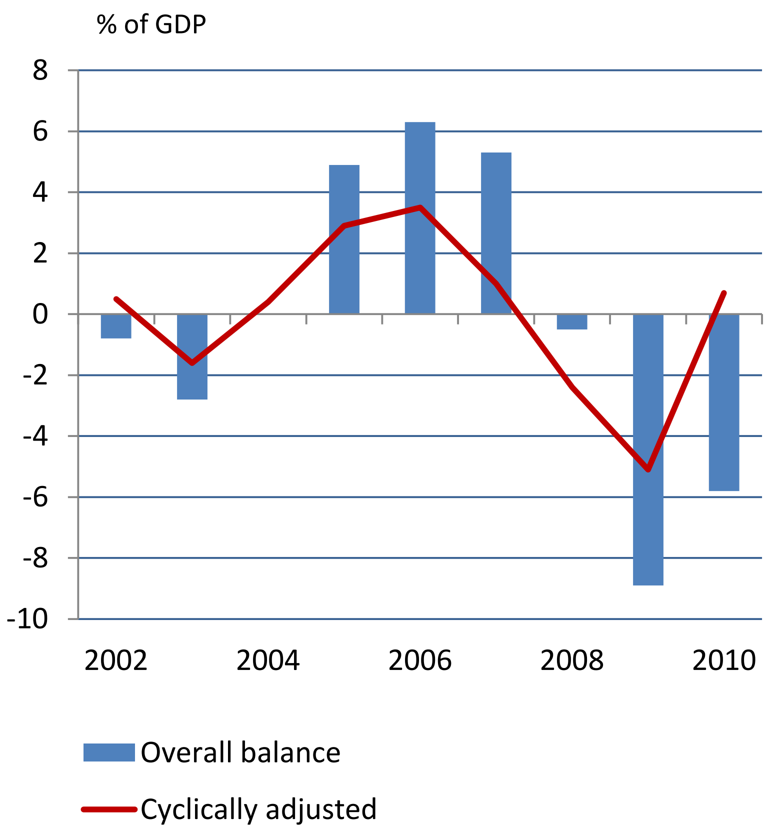
Net FDI, cumulative 2002-2008



Sources: Various Central Bank websites.

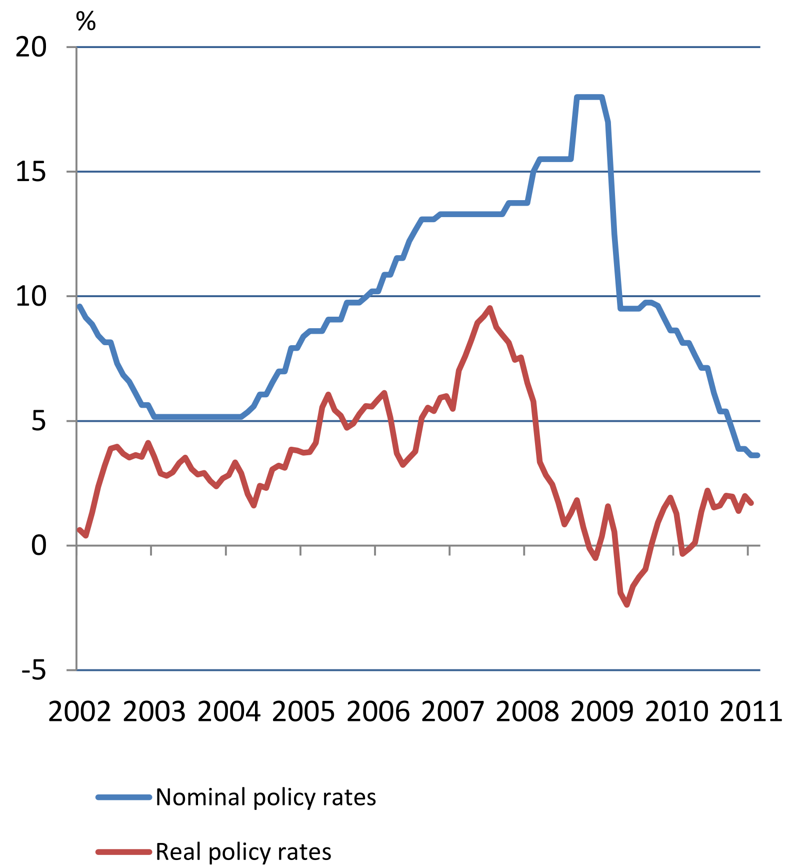
Fiscal policy was too loose and monetary policy overburdened

General government balance



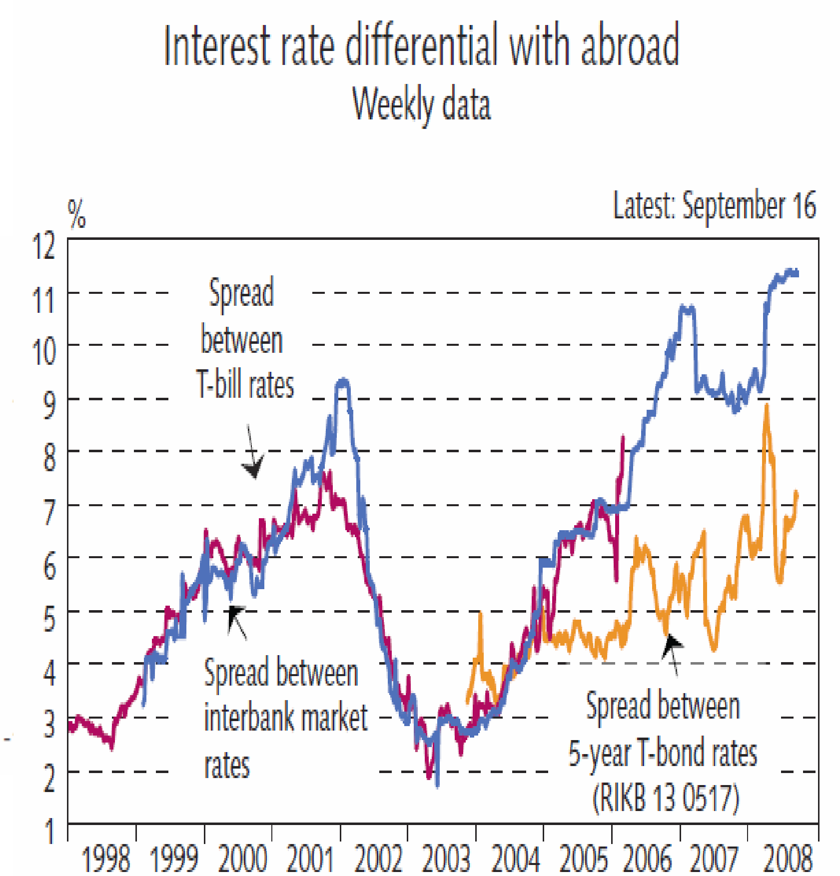
Sources: IMF, Statistics Iceland.

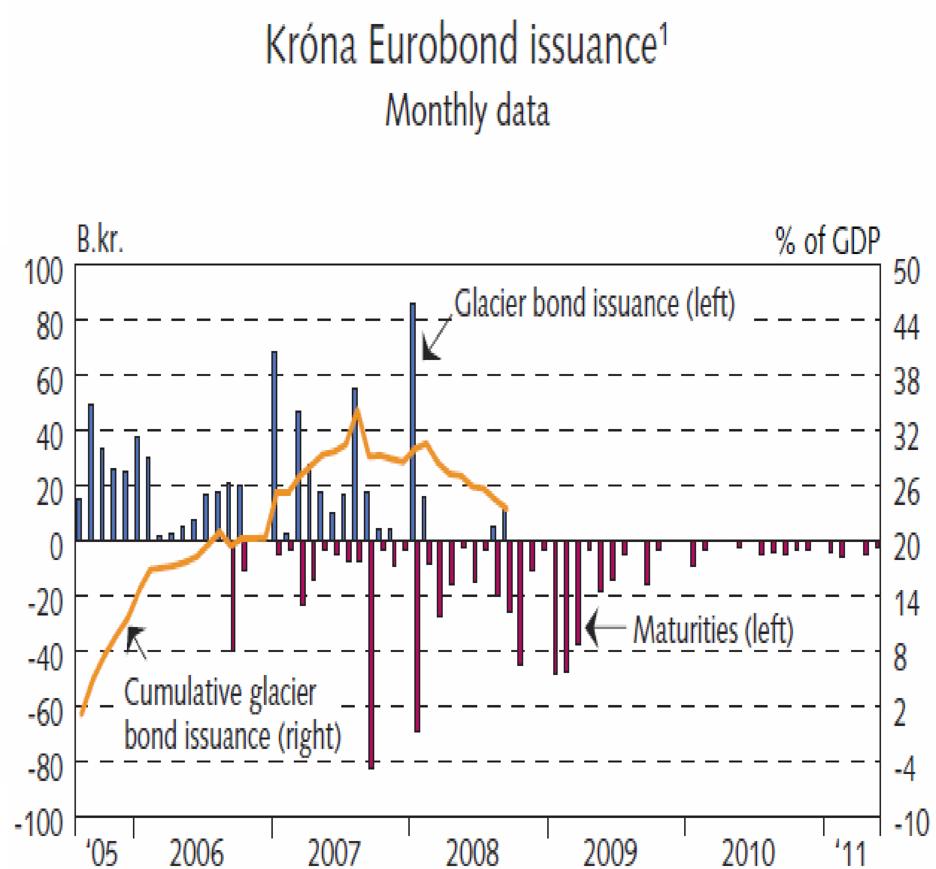
Real and nominal policy rates



Source: Central Bank of Iceland.

A wide interest rate differential induced capital inflows and encouraged carry trade

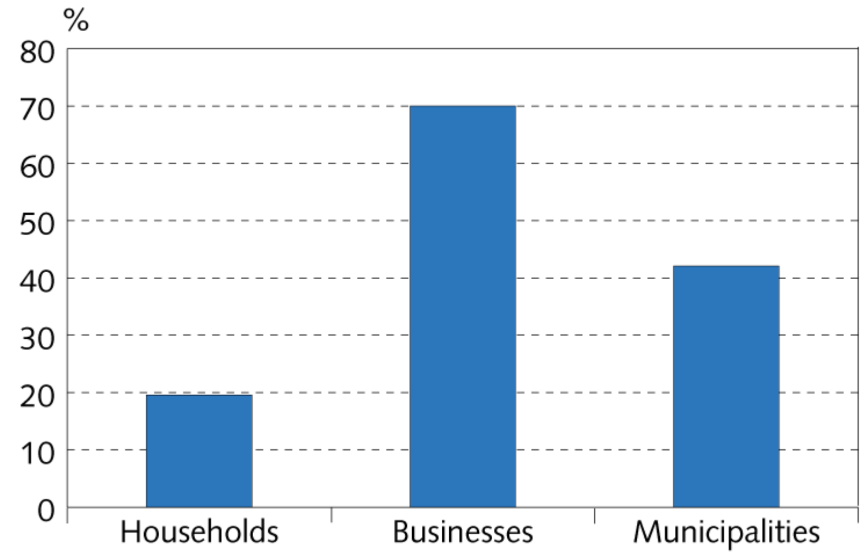




And induced foreign currency denominated lending

- In addition, 75% of total household debt was price-indexed.

Proportion of total foreign-denominated debt[1]



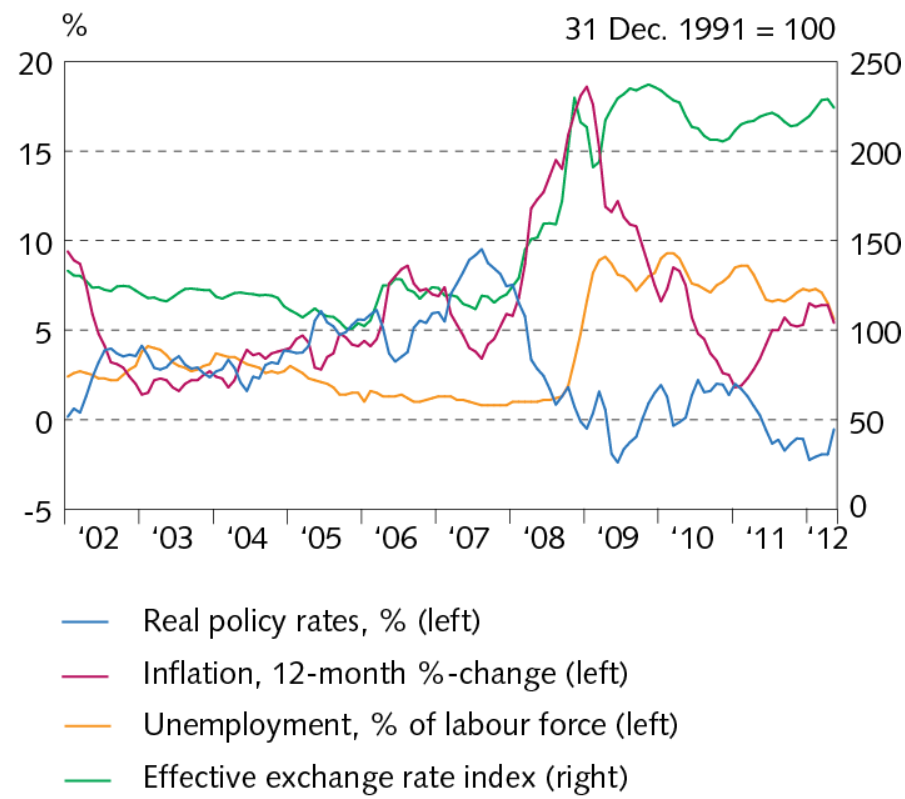
1. Figures for households and municipalities are as of year-end 2008, and figures for businesses are as of June 2009.
Source: Central Bank of Iceland.

The role of monetary policy in the crisis is hotly debated in Iceland

- Some claim that monetary policy was too loose and others that it was too tight
- Monetary policy was part of the boom-bust story – IT framework was overburdened and more tools should have been used
- But had a much smaller role in the cross-border banking crisis

Real policy rates, inflation, unemployment and exchange rate

January 2002 - May 2012



Sources: Directorate of Labour, Statistics Iceland, Central Bank of Iceland.

Flaws in the pre-crisis inflation targeting framework

- Underpinned by economic theory that abstracted from financial markets – monetary policy without money!
- The interaction between monetary stability and financial stability was ignored
- Financial globalisation creates challenges for small open and financially integrated economies (weakening of the interest rate channel of monetary transmission, volatile capital flows and "misbehaved" exchange rate)
- Problems with execution due to real economy globalisation (in the limit an undefined resource constraint)

The economic programme with the IMF and the recovery

Adjustment and three shocks

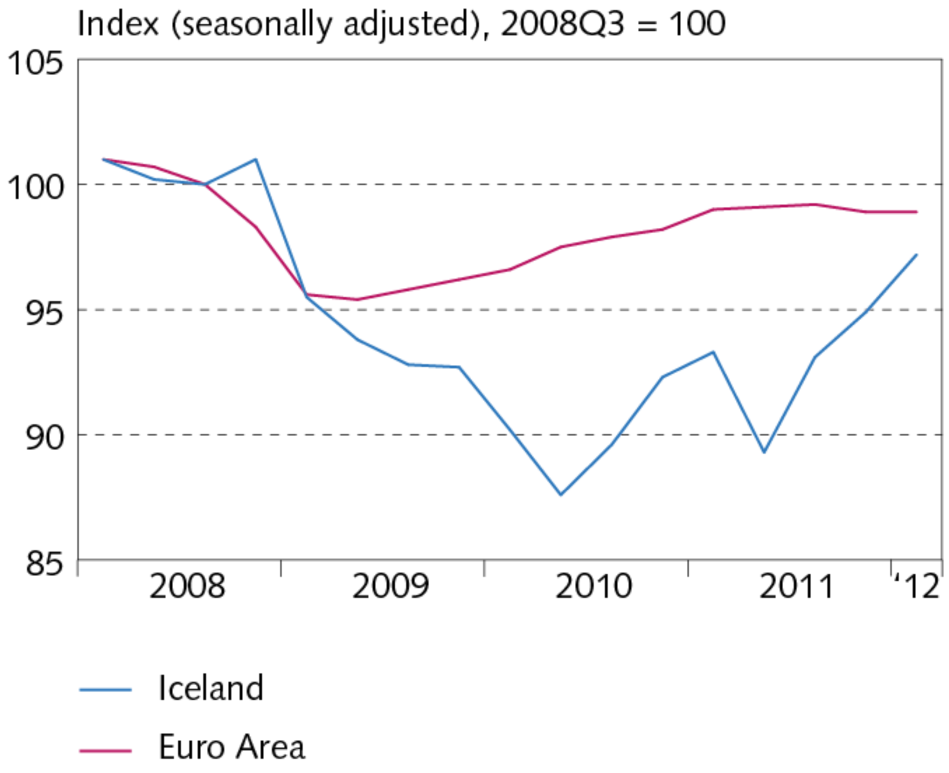
- Unusually large external and internal macroeconomic imbalances in 2005-2007.
- Their subsiding was bound to be associated with a significant slowdown, if not an outright recession (from 2006 onwards, the CBI consistently predicted a recession in 2009).
- Currency crisis in early 2008 (exchange rate fell by 26% in the first half).
- Collapse of the banking system in October 2008 (exchange rate fell by another 26% to year-end).
- Global contraction in Q4/2008 and the first half of 2009.

The policy response

- Emergency Act: intervention powers, deposit preferance, authorisation for capital injections
- Statement that all deposits in Iceland were secure
- Failing banks placed in resolution regimes and domestic banks carved out (1.7 times GDP)
- IMF programme (USD 5.1bn with bilateral loans) and three key goals: exchange rate stability; fiscal sustainability; and financial sector reconstruction
- Comphrehensive capital controls a key element in the programme

The recession was deep in international comparison

GDP level
Q1/2008 - Q1/2012



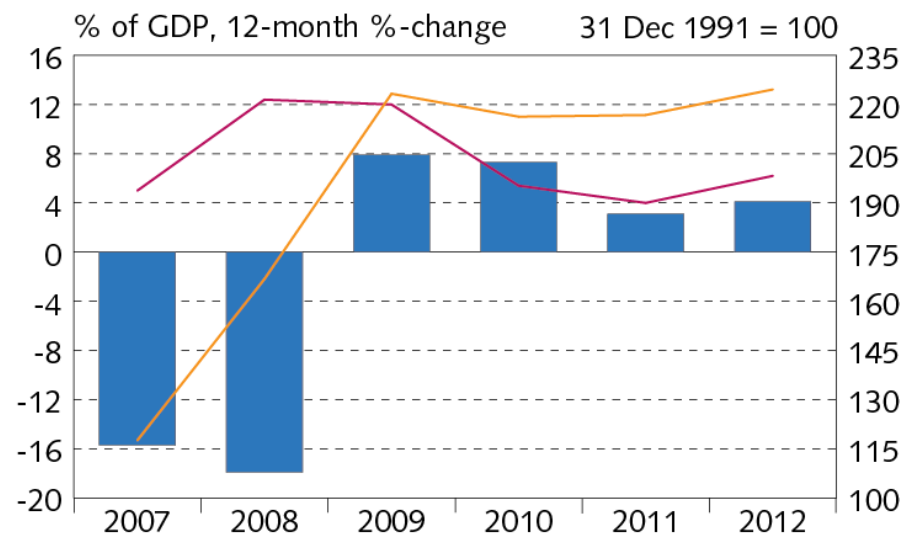
Source: Eurostat.

- GDP contracted by almost 12% from its peak in 2007Q4 to its through in the first half of 2010
- But that was a decline from an overheated level

Stabilisation

- Current account deficit of 15-20% of GDP in the years leading up to the crisis has swung into a significant underlying surplus
- Exchange rate stabilised in the 2nd half of 2009 and appreciated in 2010
- Inflation and interest rates then came down

Current account balance, inflation and nominal exchange rate 2007-2012



Current account balance excl. DMBs undergoing winding-up proceedings and Actavis (left)

Inflation[1] (left)

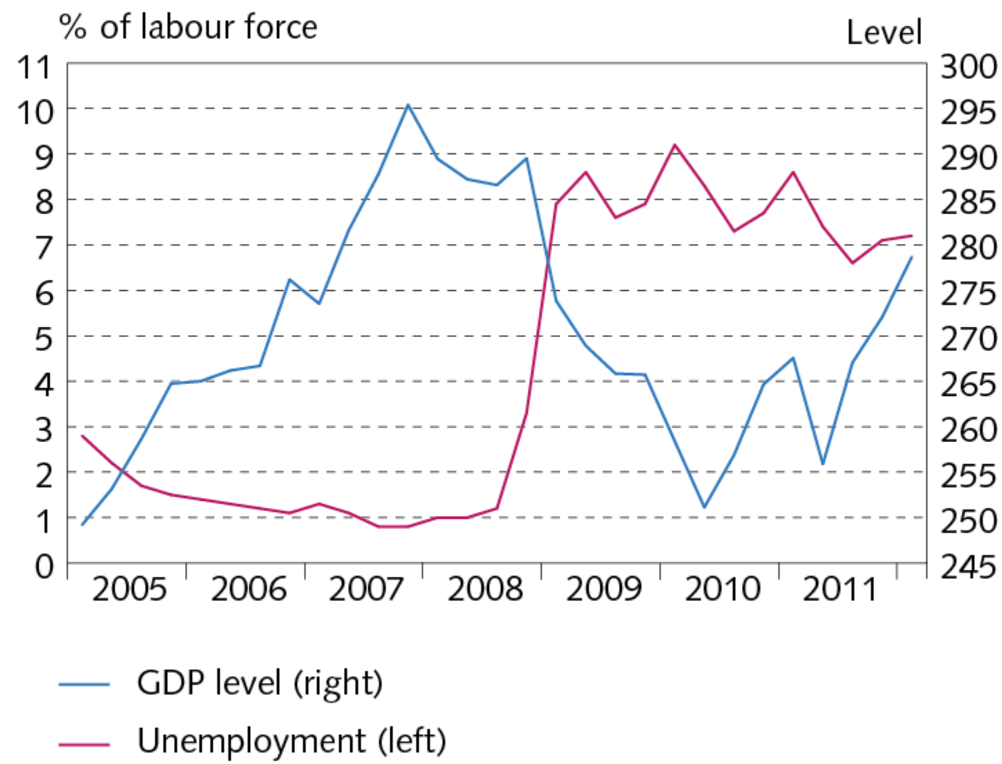
Nominal exchange rate index[1] (right)

1. For the year 2012, the exchange rate and the inflation are shown as averages from 1 January - 15 June 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Recovery

- Recovery of GDP began in the second half of 2010
- 3.1% growth in 2011 and 4.5% in Q1 2012.
- GDP in Q1 5.7% below the former peak in Q4 2007
- Unemployment has been declining (5½% s.a. in May)

GDP level and unemployment
Q1/2005 - Q1/2012



Sources: Directorate of Labour, Statistics Iceland.

Current policy challenges

Policy challenges

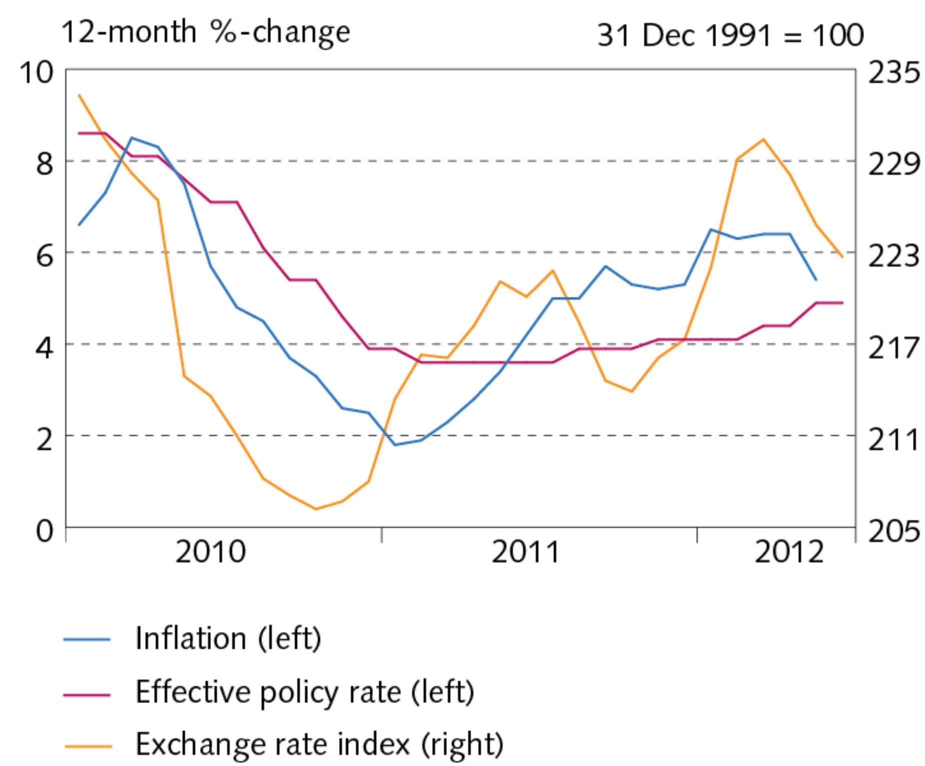
- Keeping the momentum of fiscal consolidation through the political cycle
- Getting inflation back to target
- Lifting controls on capital outflows

Monetary policy and inflation

- Inflation has increased significantly since reaching target in early 2011
- Fuelled by exchange rate weakness and high wage increases, which in turn are fuelled by the strong position of export sectors
- Monetary policy has reacted by increasing the policy rate by 1.5 percentage points since August 2011
- Negative real rates supported the recovery

Inflation, exchange rate index and effective policy rate

January 2010 - June 2012

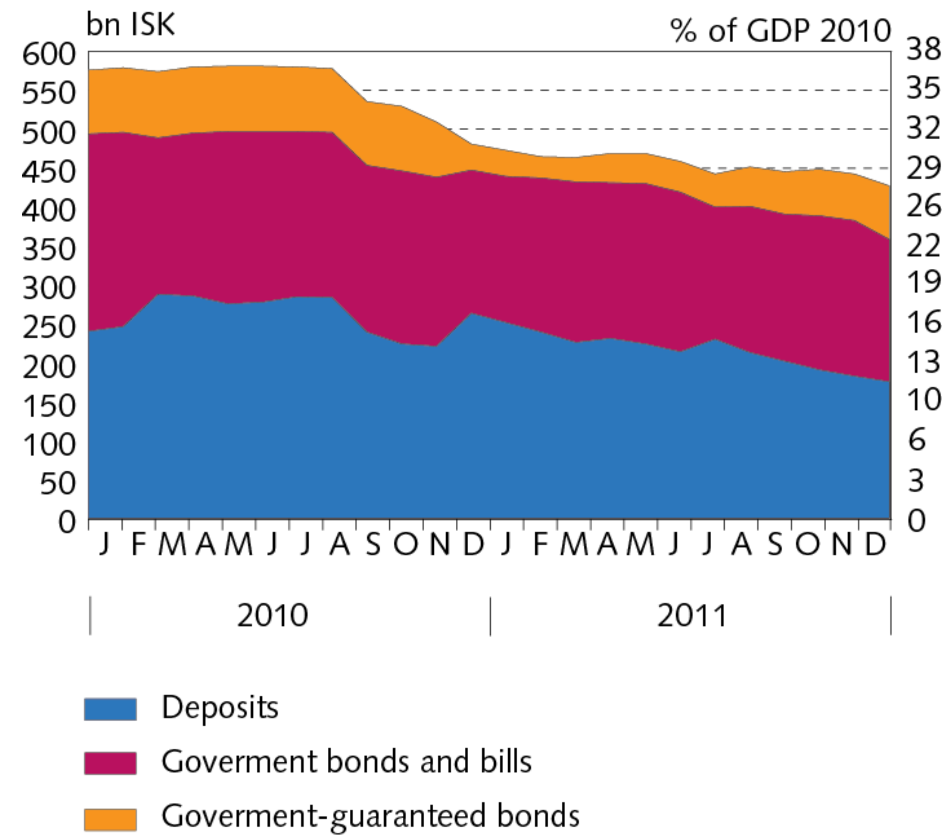


1. For June 2012, exchange rate is shown as an average from 1 June - 15 June.
Sources: Statistics Iceland, Central Bank of Iceland.

Lifting capital controls: the overhang

- Liquid króna positions held by foreigners are a legacy of the capital inflows and carry trade before the crisis
- They are a key obstacle in the way of lifting controls on capital outflows
- Have been reduced through auctions and bilateral deals
- 12% of GDP will be added by estates of failed banks but will be off-sett by somewhat bigger FX payments to residents

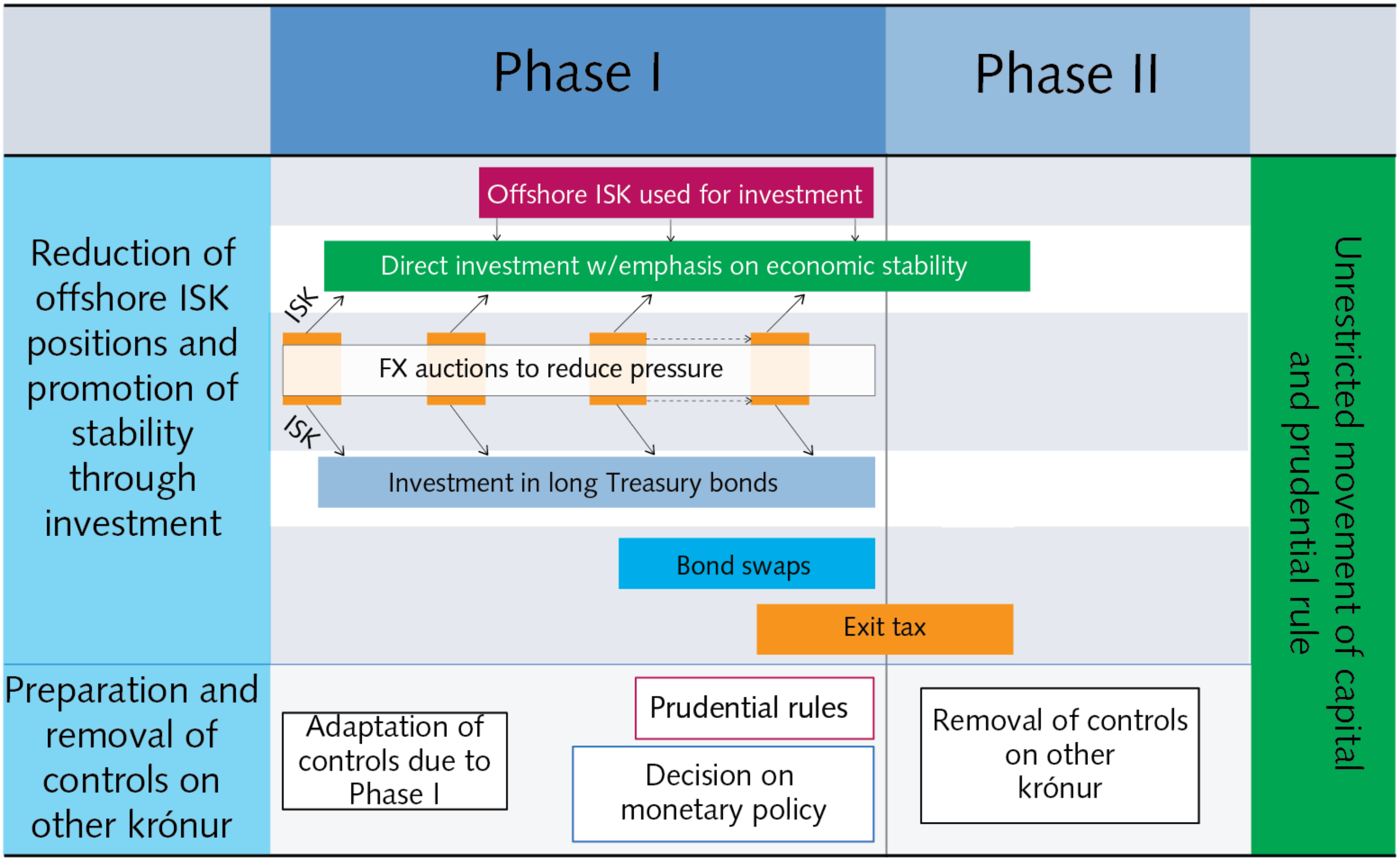
Non-residents' ISK assets



Source: Central Bank of Iceland.

The strategy for removing capital controls

Capital account liberalisation: Phases and steps



New directions?

Monetary union?

- Monetary union would reduce the financial integration problem for macroeconomic management in small open economies
- Also beneficial from the financial stability standpoint:
  - Reduces the risk of currency crisis
  - Cross-border banking activities less risky – large and credible LOLR
- But the current crisis in the euro area raises questions
- The flexible exchange rate is to a degree both the problem and the solution

Inflation targeting plus

- Managed float instead of a free float
- Dealing with the capital flow problem: restrictions on international activity and FX risks of banks (including maturity mismatch in FX); restrictions on FS lending to unhedged borrowers; levies or reserve requirements on excessive capital flows
- Better support of fiscal policy: avoid policy conflicts
- Macroprudential policy and tools
- Monetary policy and financial stability: lean and not only clean