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Iceland's monetary policy regime

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Based on

“Reassessing Iceland's Monetary Regime”
by Patrick Honohan and Athanasios Orphanides

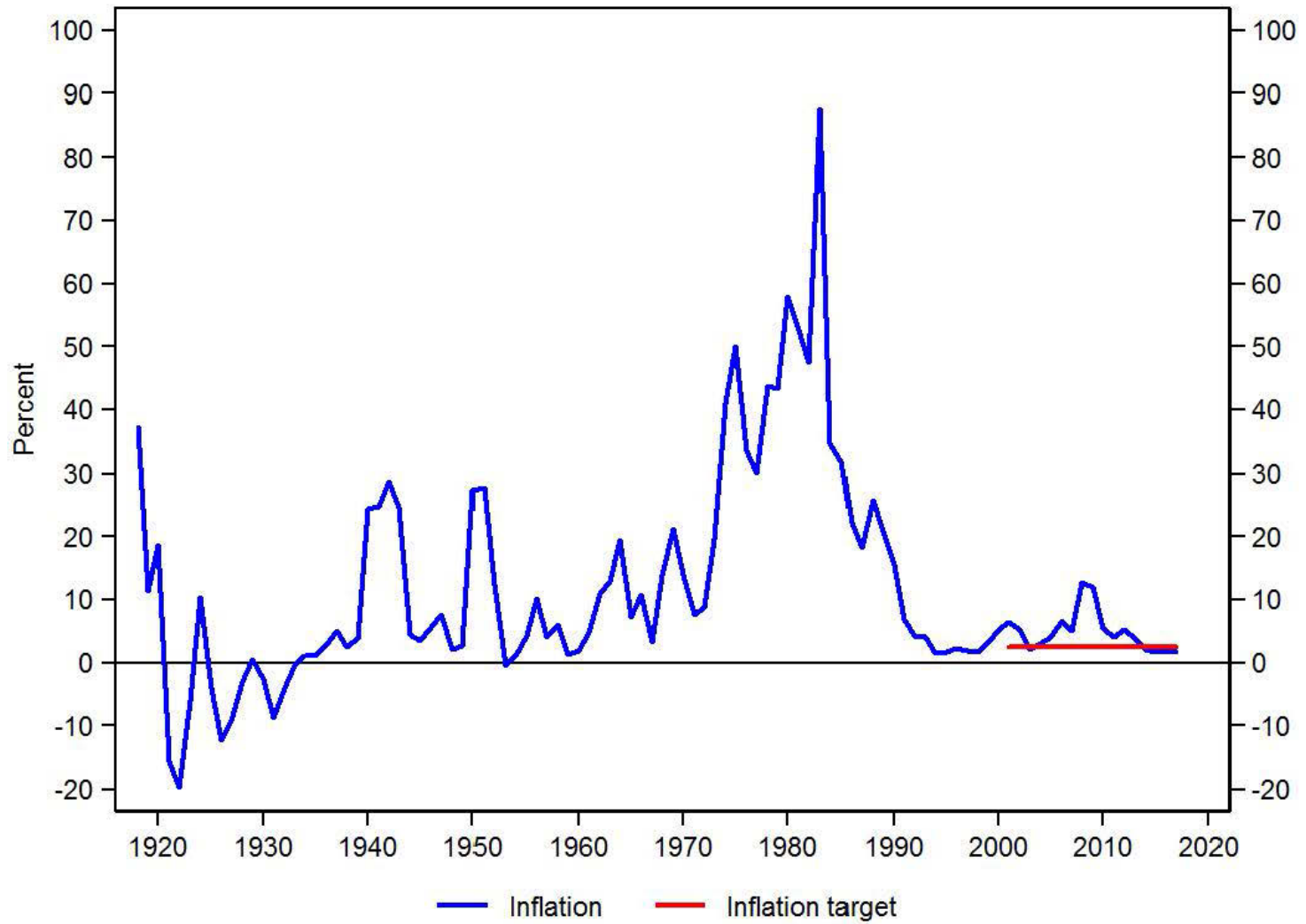
Monetary policy issues we noticed

- Inflation is **on target**
 - Thanks partly relatively **high interest rates** (building reserves)
 - And some **luck**
 - Even though **real growth strong**
- But stripping out **house price** component shows that other prices have been falling
 - **CPI may mislead** in the short run
- **Exchange rate volatility** a complicating factor for policy
 - **Wide movements destabilize real economy and inflation**
- As is the prevalence of **index-linked mortgages**
 - Which **weaken transmission** of monetary policy
- **“Macroprudential” tools** are needed relevant for monetary policy also
 - Including effect on **pension fund** lending
- This suggests **governance changes**
 - **Merge CBI and FME**

What we noticed about Iceland's chequered inflation history

- Economy vulnerable to shocks
- Depreciation was used to respond to shocks
- With limited success in terms of real economic activity
- Inflationary surges a side-effect
- By the early 1990s an anti-inflation consensus had built and soon inflation came under control.
- Though slippage returned even after formal inflation target (IT) regime introduced in 2001

Inflation



Ensuring price stability - 1

- Price stability is the core task of any central bank.
 - It is measurable. So CB can be held accountable
 - Don't water this down.
- We examined how CB is doing this job and find it generally in line with international consensus....
- [We make some suggestions including
 - To improve communication
 - To avoid destabilising effect of house prices on the targeted CPI]

Ensuring price stability - 2

- But some Iceland-specific aspects deserve attention
 - Prominence of **index-linked housing loans** (not so easily steered by CB using short-term interest rates)
 - Large **role of nonbanks** in the housing finance market
 - Importance and **volatility of exchange rate**
- Make sure the CB has the tools to do the job and is willing to use them:
 - **Macroprudential** tools to augment interest rate policy
 - Willingness to use **FX intervention** especially to restrain unwarranted FX appreciation surges
 - (But be careful with unrealistic attempts to resist depreciation)
 - If necessary including taxes/controls on currency speculation – but don't lead with these

Ensuring financial stability

- Financial stability is also a key task of equal if not greater importance—but **don't weaken commitment to price stability**
- **Communication between prudential regulator and monetary policy** is vital
 - The policy measures taken by each influences the ability of the other.
- In a small country better to merge into one institution.
 - But even then it will be vital to ensure **perfect flows of information and policy interaction** between prudential regulator and the bank
 - Some intrusive macroprudential tools should continue to require political approval – but to avoid inertia, **CB's proposals should be published even if not politically accepted**

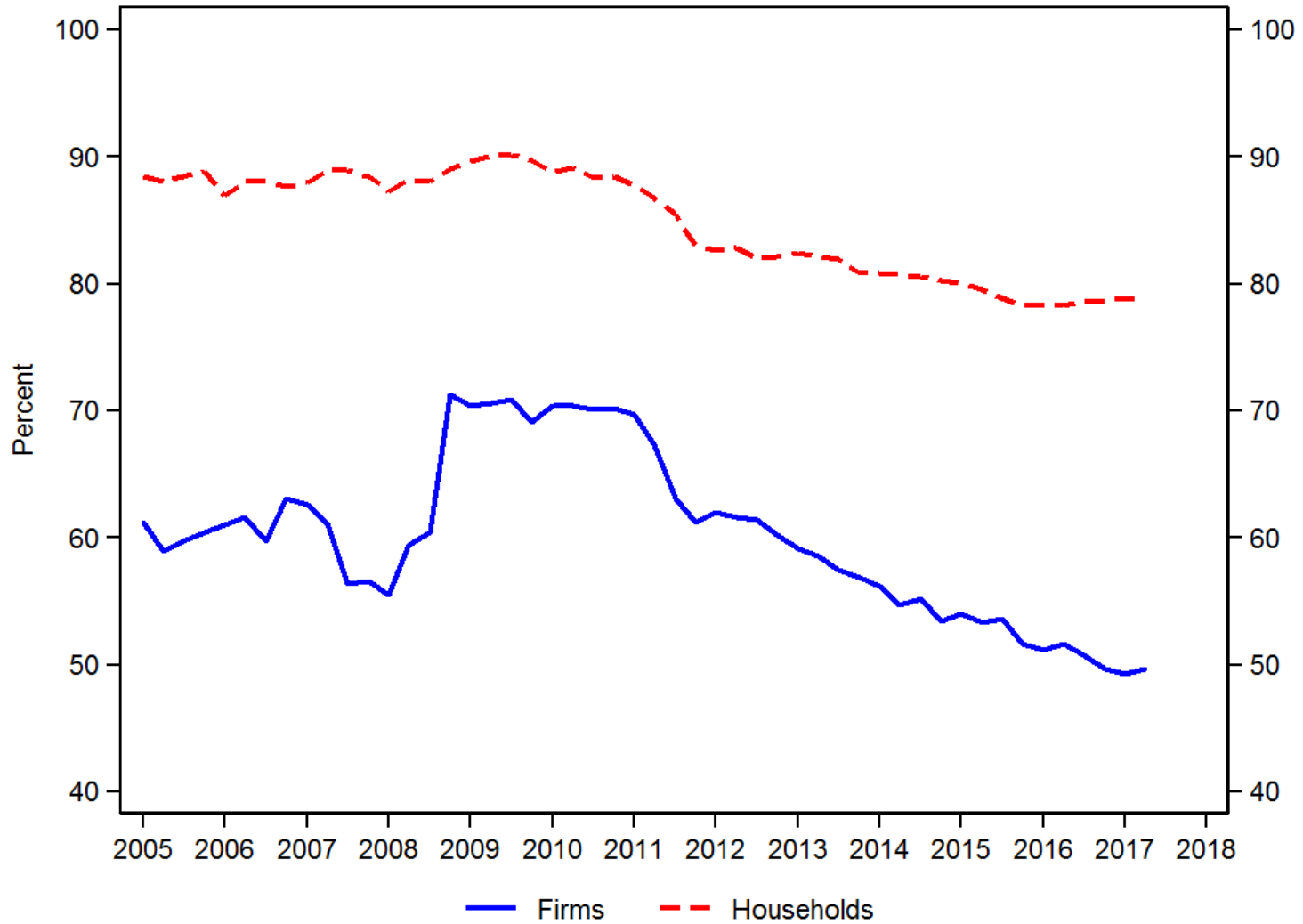
Ensuring price stability - 3

- Price stability is the core task of any central bank.
 - It is measurable. So CB can be held accountable
 - Don't water this down.
- A new mandate?
- Prioritising financial stability over price stability in a new mandate could seem unexpectedly **out of step** with international practice and trends...
 - (cf Norway, New Zealand, etc)

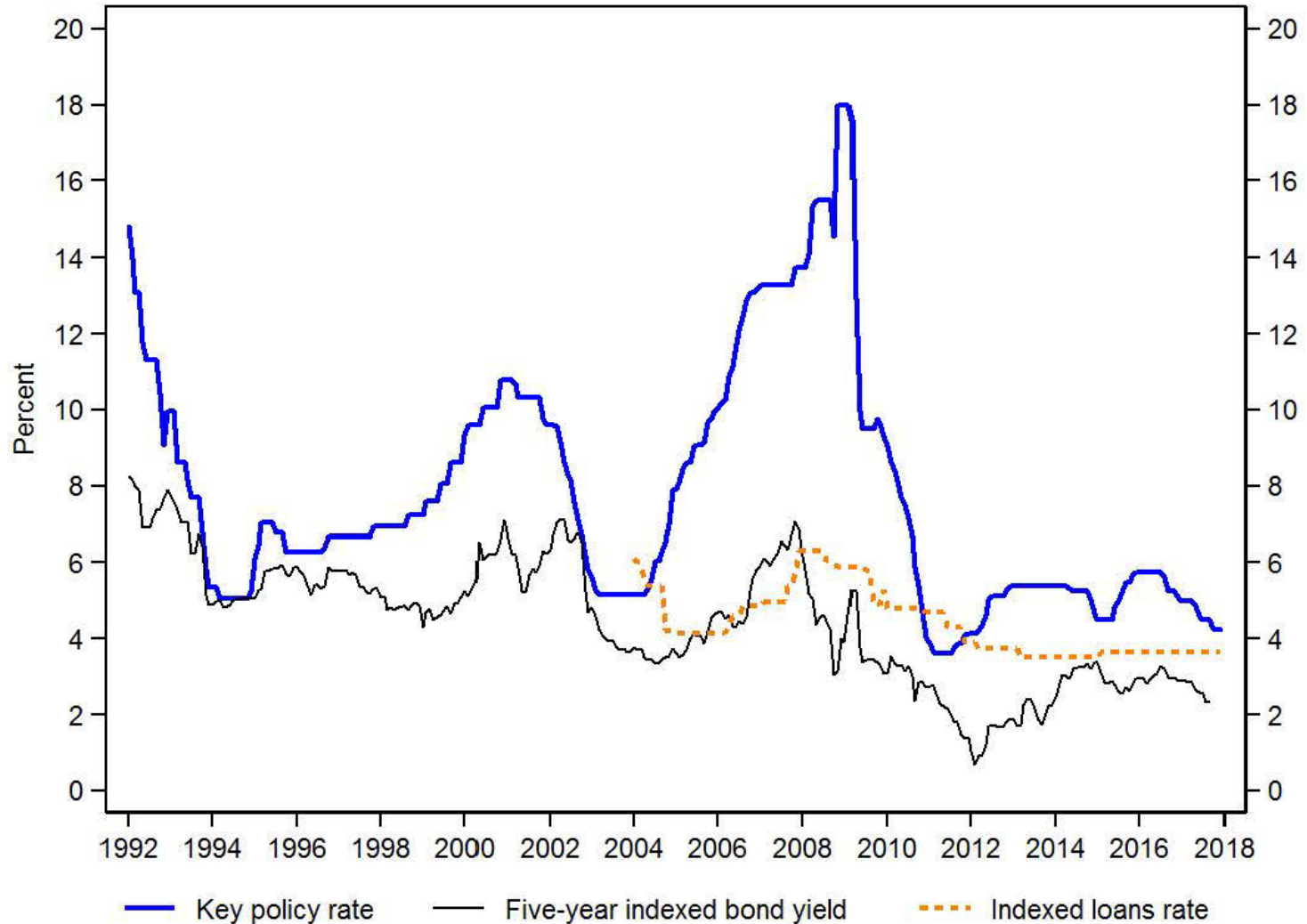
Indexed mortgage loans and the role of pension funds in housing loans

- Pension fund activity very relevant for macroeconomic stability.
 - (These large institutions also raise important competition and prudential issues)
- Indexed interest rates may not respond sufficiently strongly to monetary policy nominal interest rates
- So policy rate may need to be supplemented by macroprudential tools
- Close cooperation needed between monetary policy and prudential regulator
 - (Why not merge these – in a small economy)

Share of indexed and foreign exchange debt



Key policy rate and indexed interest rates



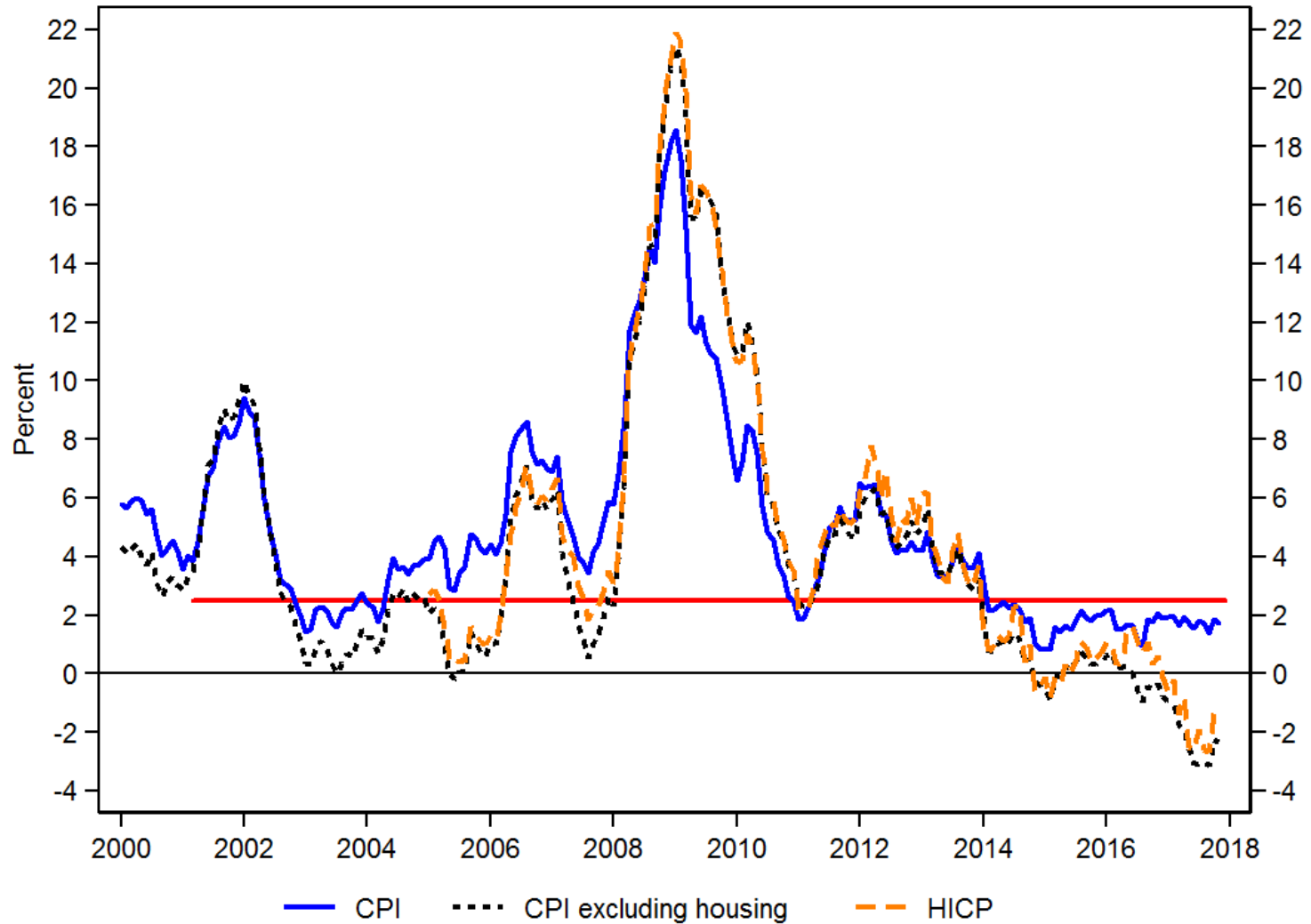
Exchange rate

- Recent stabilization has seen rapid exchange rate appreciation
 - Partly a consequence of high interest rates
- Maybe converging to new equilibrium real exchange rate reflecting tourist boom
- Fixed exchange rate a viable option? We say no!
 - (e.g. too vulnerable to speculation)
- But Sedlabanki could use tools to limit large exchange rate appreciation more aggressively

Housing component of CPI

- Is measured professionally within international standards,
- But emphasizes short-term housing price movements more than is useful for inflation targeting
- Recently CPI inflation on target but non-housing prices were falling
- Sedlabanki should allow CPI to deviate from target temporarily if housing prices are moving rapidly

Headline inflation and inflation excluding housing



Communication issues

- Does the general public really understand what the central bank is for and what it is doing?
 - This will become more important with wider range of responsibilities
- Individual votes of monetary committee members should be published more promptly
 - Committees work better for these decisions than individuals.
- CB proposals (even rejected) on macropru should be published (as mentioned)