May 7, 2008
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A few points on monetary policy

presented on the occasion of a visit by the Gissur hvíti Oddfellow Lodge to the Central Bank of Iceland

I would like to discuss briefly a few matters of current import, from the point of view of the Central Bank. I will also touch on two subjects that have been in the limelight recently: price indexation of loans and the adoption of the euro in Iceland.

The economic skies have clouded over in the recent term, but there is no reason to despair. We have a job to do, and the Icelandic economy has demonstrated that it has the flexibility necessary to work through the situation at hand. But it is critical that we be aware of the problem and try to learn from experience.

Double-digit inflation calls to mind a bleak chapter in economic history – one that young people only know by hearsay. The past few weeks' decline in the exchange rate of the króna is causing a spurt of inflation at the moment, but the real roots of the problem are deep and complex. It is of paramount importance that we not lose control of inflation and that we achieve better balance in the economy. Imbalances manifest themselves in inflation and a wide current account deficit, which is caused by strong demand – in particular, by vigorous consumption. We have spent beyond our means and have based a portion of that spending on borrowed funds. Because of burgeoning demand, asset prices rose sharply for a while, but that trend has now reversed. For quite a while, real disposable income – that of households and businesses alike – was much higher than potential growth in export revenues could support. Hefty foreign debt and a wide current account deficit made the Icelandic króna a handy target for investors. A high exchange rate and interest rates also play a part. But interest rates would not have had to be as high as they are if the Icelandic economy had been calmer and if consumption had not been as brisk as it has been in the past several years. The saying about its being better to have less bulk and more balance is certainly applicable here.

It has been suggested that the Central Bank should lower interest rates despite high inflation and a poor inflation outlook. What this entails is a request to surrender to inflation, which would be a dangerous move. It would have been more beneficial to control demand earlier through increased private savings. But this did not happen, and unfortunately, it appears as though the necessary economic adjustment will be a rather harsh one.

Containing inflation is no simple matter. In the past several years, a variety of forces have compounded the overheating of the economy and thereby increased the risk of inflation. The construction of the aluminium smelter and power plant in East Iceland are generally mentioned in this context, as that project was an unusually large one. But that project took no one by surprise and would not have caused inflationary pressures by itself, partly because imported labour was used so extensively. The surge in general demand is another matter, however. Holding inflation near 2.5% would have been easier if demand had been less. But demand was robust because of wage rises, tax cuts, the general optimism that accompanied high employment levels, and – most important – ready access to long-term loans at interest rates that continued to decline for a time. As is well known, when the Housing Financing Fund liberalised its lending rules, the banks viewed this as a threat and began competing head-to-head in the mortgage finance market. Both developments were unfortunate – both the liberalisation of HFF rules during an economic upswing and the fact that the banks should add fuel to the fire with vigorous mortgage lending that greatly stimulated overall consumption. The less the restraint in other areas, the more restrictive the Central Bank must be in order to fulfil its mandate of keeping inflation near the 2.5% target. It would also have been helpful if it had been apparent earlier on just how decisively the economy had recovered from the slump right after the turn of the century. Just like others, the Central Bank is always uncertain what turn the future will take, how to assess the status at the current moment, and unfortunately, how to assess the developments of the years just past. We hope it will be possible to find ways to improve economic indicators.

Assumably, everyone in Iceland would like inflation to remain low. The Central Bank has been assigned the task of holding inflation near 2.5%, similar to what is done in our chief trading partner countries. Based on the tenor of public debate, it is tempting at times to draw the conclusion that this target is too stringent, and even that it is possible to set the target aside temporarily. But if we do that, we run the risk that inflation will become entrenched at higher levels than otherwise, and perhaps that the familiar wage-price spiral will develop once again, with even higher inflation in its wake. When so many forces work against the goal of low inflation, there is a greater likelihood that the Central Bank will be forced to wield its tools in a manner that generates unpleasant side effects. This is why it is desirable that others join hands with the Bank in shouldering the responsibility for the inflation target. Large wage increases, for example, are undesirable if there is the risk that they will infect the entire pay scale, even though the original intention may be that they affect only a small group. The commercial banks must exert caution in granting credit, and wage earners and borrowers must take care to handle their money responsibly. It would be beneficial as well if Icelanders had a stronger propensity to save.

Others marvel at how high our interest rates are in comparison with our neighbouring countries, even when the economy is not overheated. There are two clear reasons for this: first, we have a history of high inflation, and second, we save very little – or, in other words, we consume a great deal. If we are to bring interest rates down to the levels in neighbouring countries, our economy must exhibit other characteristics of those countries; for example, we must achieve sustained low inflation, and we must develop a sense of contentment with what we have instead of yielding to a persistent desire to spend more.

Because of our experience with high inflation, we adopted price indexation of liabilities nearly 30 years ago. Indexation had previously been used to a limited degree; for example, Treasury bonds were indexed. It is sometimes maintained that indexation should be abandoned in Iceland, but the rationale behind this argument varies. One idea is that abolishing indexation is necessary in order to bring inflation into line. Another is that borrowers' loan costs would be lower if indexation were abolished. And finally, it is maintained that abolishing indexation would improve monetary policy transmission so that the Central Bank's interest rate changes would penetrate through the economy sooner. The first two of these suggestions are based on misconceptions, and although there is a certain amount of truth in the third, it would be extremely unwise to try to abolish indexation in Iceland through legislation. On the other hand, it is quite feasible to continue to use it sparingly. Market developments are most conducive to such a reduction, but it can be expected that a long time will pass before indexation will be discontinued entirely, if it ever is. For quite some time, the Treasury has set a good example by issuing non-indexed bonds.

The experience of the past few decades shows that inflation can be low in Iceland despite the widespread use of indexation. In the 1990s, for example, inflation was much lower than in previous decades in spite of indexation. This shows clearly that it is incorrect to maintain that inflation cannot be contained if price indexation is practised. It is also a mistake to assume that borrowers' costs will drop merely because indexation is discontinued. Indexed loans are actually less expensive than their non-indexed counterparts, and this can be proven with a comparison of the figures that pertain. The reasoning is that lenders do not have to add a risk premium to the interest rate on the loan in view of the uncertainty about inflation.

By taking an indexed loan, the borrower is actually taking a new loan with each rise in the CPI. Because of this, the outstanding balance does not decline until late in the loan period, even though payments have been made regularly. It also means that, in real terms, the debt service remains relatively stable throughout the term of the loan but drops as a proportion of wages if the borrower's disposable income rises. It is possible to avoid an ever-increasing outstanding balance by paying the indexation as an extra instalment on each due date. This would increase debt service early in the loan period, in comparison with the conventional treatment of an indexed loan, and it would suit the banks quite well also, as they finance their loans partly with short-term capital. Banks also have an easier time granting non-indexed long-term loans if the interest rates are variable. In such a case, the borrower would not be bound by the CPI but would have a heavier debt burden early on in the loan period. There is every reason to conduct a thorough examination of the future arrangements for mortgage lending in Iceland as soon as possible. For example, it appears as though it would be a positive option if the Housing Financing Fund were to provide the banks with long-term funding obtained through the sale of indexed housing bonds, and if the banks were to continue developing their housing finance options, as has been mentioned here. It would also be possible to reduce indexation by offering two-part mortgage loans, with one part indexed and the other part non-indexed but with a variable interest rate. Another possibility is that the HFF and the banks could work together to develop new mortgage finance products.

Foreign-denominated loans bear lower interest rates than loans in Icelandic krónur do, but the Central Bank has repeatedly advised those without income in the currency in question to exercise caution with respect to foreign loans. In view of the developments of the past several weeks, it is instructive to read once again a paragraph that appeared in the November 2007 issue of the Central Bank's *Monetary Bulletin* (page 25): "Foreign borrowing has recently increased sharply, and the share of foreign currency-denominated loans in total household borrowing has risen. Currency composition of such loans has also shifted notably in recent months, with the share of low-yielding currencies such as the Swiss franc and Japanese yen increasing. Such loans are subject to both interest and foreign currency risks. The share of foreign loans has continued to increase despite the króna's strength. The farther the króna's real exchange rate moves away from its equilibrium level, the greater the probability that the króna will weaken over the long term, thus increasing the risk of new foreign currency loans. Judging by exchange rate developments over the past couple of years, the debt service burden of foreign loans has probably been less than that of indexed domestic loans, but that situation could change quickly."

Various things are said about the Central Bank, some understandable and some not. It has been said that the Bank has lost credibility because of its monetary policy and that it is necessary to recruit more qualified senior management, including foreign experts. If only the solutions to economic problems were this simple. Foreign experts discuss Iceland's economic affairs on a frequent basis. Specialists from the Organisation for Economic Co-operation and Development (OECD) and the International Monetary

Fund (IMF) have been vociferous in encouraging Iceland to follow a conservative monetary policy.

It is not particularly enviable to be the subject of discussion by journalists with varying amounts of knowledge of their subject. Just recently, I found myself between quote marks at the hands of a Danish journalist, and the things I said to her in no way supported the conclusions appearing outside those quote marks and in the title of her article. Journalists bear considerable responsibility on their shoulders. Fortunately, most of them handle that responsibility with great skill. But if they decide to concentrate on a more negative angle than is justified by their material, either because of their own inclination or because of orders from above, the playing field is no longer equal because they have the ultimate power to decide what the public sees.

Some of the criticism levelled at the Central Bank is actually prejudice that, in my opinion, is based on fallacies. For instance, it has been said that the Central Bank is strongly opposed to adopting the euro because it would obviate the need for the Bank's existence. Of course, there should be calm and reasoned discussion of Iceland's possible membership in the European Union and the European Monetary Union. But that is a long-term issue that must first be resolved in the political arena. Adoption of the euro is not a comprehensive solution to Iceland's current problems, and debate about the euro must not overshadow the discussion of the steps that we must take in order to achieve a more balanced economy. Unilateral adoption of the euro is one option that has been mentioned, but it would be an extremely unwise move because Icelandic financial institutions do not have access to a central bank that issues euros. That being the case, financial institutions should be the last to promote such an irresponsible decision. They must realise that this is a long-term issue that, for the present, remains unsettled. The fact is that we live in a small country with a small economy, and we use the Icelandic króna. Both the economy and the currency could be changed, but it would take a long time, and harbouring delusions about the matter could prove detrimental.

The chairman of the board of a financial institution stated recently that he believes there are political reasons behind the Central Bank's not granting that company permission to register its share capital in euros, and that this has harmed the company's shareholders. This is a fundamental misapprehension. The Central Bank does not have the power to approve or reject an application to register share capital in other currencies. If shareholders have incurred any loss because the company's shares are not listed in euros, that loss is entirely the responsibility of the senior management of the company concerned. Companies that are listed on a regulated securities exchange have the statutory authority to register their share capital in a currency other than the króna, whether it is sensible to do so or not. In order to have its shares issued electronically, the company can have them listed abroad. It is my understanding that the Icelandic Securities Depository will soon be able to provide this service in Iceland, which is a positive development.

It is also a misunderstanding to assume that membership in the EU and the EMU would obviate the need for the Central Bank of Iceland's existence. Central banks in EMU countries play an important role within the central banking systems of those countries, in addition to having been instrumental in preparing for their countries' entry into the European community. But I would like to reiterate that this is a matter that must be resolved in the political arena over an extended period of time. If any financial company in Iceland thinks it can force the adoption of the euro by carrying out its accounting in euros or changing the listing of its share capital, that company is sadly mistaken. As regards possible formal discussions of EU membership, it is also well to bear in mind that Iceland's negotiating position would not be terribly strong if we were forced to apply for membership.

I make no attempt to underestimate the benefits of membership in a currency union. But it is just as well not to overestimate the benefits either, and the last thing we must do is to tempt ourselves with the notion that EMU membership would solve all our problems. Neither inflation nor the current account deficit would vanish merely because Iceland set its sights on joining the EMU. A report published by the Office of the Prime Minister in 1998[1] states as follows with respect to the benefits of the EMU: "A common currency eliminates foreign currency risk and uncertainty in internal trade among member states, thereby promoting greater efficiency in business." Furthermore: "A common currency reduces direct currency costs in cross-border trade." But concerning the disadvantages, it states: " … the risk of increased unemployment during economic contractions is one of the principal risks accompanying participation in the EMU." The report asserts that only those countries that are EU member states may participate in the European Monetary Union. Although that report is nearly ten years old, it can still function as a foundation for discussions of the EMU, as can the Central Bank's 1997 report on the same subject.[2]

Recent public discussion supports the conclusion that some critics believe the "tiny króna" to be the main reason why Iceland should aim at joining the EMU. This sort of talk implies a declaration that there is little hope of our being able to conduct our economic affairs sensibly without acting on instructions from others. There is some truth in the assertion that the framework of the Icelandic financial system is narrow if it is deemed

[1] The impact of the European Monetary Union on the Icelandic economy. Office of the Prime Minister, June 1998.
[2] The European Monetary Union – EMU. Publication #2. Central Bank of Iceland 1997.

necessary that Icelandic financial institutions maintain extensive operations abroad. But is it necessary? An experienced member of the banking community said recently in a radio interview that the banks should tailor their growth to the suit of clothes available to them. Wouldn't it be advisable to wait until the suit of clothes has been re-designed, if it is to be altered at all?

Are the banks too large for Iceland, or is Iceland too small for the banks? Conditions in financial markets all over the world have changed dramatically in a very short time, with the result that the banks now have more difficulty accessing credit. They grew rapidly during a period of advantageous global market conditions, but this business model must change. The solution to the banks' problem is primarily in their own hands. Perhaps it involves their unwinding their position to some extent – selling assets and paying debts. The Central Bank will do everything in its power to support financial institutions' attempts to reinforce confidence in their operations, including strengthening its foreign reserves; however, it is not possible at this point to specify when or by how much. On the other hand, it is appropriate to bear in mind that maintaining large foreign reserves is quite costly. Furthermore, it is absurd to view the Central Bank of Iceland as a lender of last resort in any currency that happens to be needed. The Central Bank issues Icelandic krónur and provides conventional central banking services in its domestic currency.

Based on these considerations, it should be clear that the most critical tasks at hand are two: that Iceland's banks navigate the current stormy seas without mishap, and that we as a nation reduce inflation and narrow our current account deficit substantially. And if we are to succeed at these tasks, there is plenty of work for all of us to do.