5. November 2010

Már Guðmundsson:

Economic situation and outlook and monetary policy

Speech at a breakfast meeting of the Iceland Chamber of Commerce, 5 November 2010

Mr./Madame Chairman, honoured guests,

The Iceland Chamber of Commerce has a long tradition of holding a breakfast meeting shortly after the Central Bank has published its new macroeconomic and inflation forecast early each winter. This year and last year, the publication of that forecast has coincided with the announcement of the Monetary Policy Committee's interest rate decision. The Central Bank welcomes this initiative. It is important to be able to explain monetary policy decisions as fully as possible, and this meeting has always been a good opportunity to do so. It is particularly important at this juncture, when monetary policy is formulated under unusually complex circumstances.

Effective, forward-looking monetary policy is always complex, of course, as it is formulated under conditions of uncertainty about the current situation and future prospects for the economy. But in our case, three new factors are added to an already complex situation. First of all, there is great uncertainty about the effect of monetary policy measures on the financial markets and the real economy in the wake of the financial crisis. Second, there is the question of the relative weight of exchange rate stability, as is emphasised in the Stand-By Arrangement with the IMF, and forward-looking monetary policy, which aims to anchor inflation expectations and attain the inflation target while combating the slack in the economy. The third complicating factor is the interplay between monetary policy and plans to lift restrictions on capital outflows.

But before I turn to these questions, I would like to discuss the current outlook and future prospects for the Icelandic economy. I believe we are at economic crossroads, as we have taken considerable strides towards stability, whereas robust recovery has been elusive.

First, let us consider the signs of stability. External imbalances have vanished. The staggering current account deficit from the upswing years has turned into a sizeable underlying surplus, which excludes interest that has been accrued by the estates of the failed banks but will only be paid in part. The underlying current account surplus supports the exchange rate, but the capital controls do so as well. The króna stopped falling in mid-2009 and has needed no support from foreign exchange market intervention since early November 2009. So far in 2010, the króna has appreciated by over 12% in trade-weighted terms. Since the end of August, the Central Bank has actually been leaning in the other direction and has bought about 3 b.kr. worth of foreign currency. This is not a large amount, of course, but a modest beginning can grow into something large, and it will be possible to step up the purchases when foreign currency inflows increase from current levels.

The stability and subsequent appreciation of the króna have played a leading role in the recent disinflation episode, with inflation falling from 18% in early 2009 to 3.3% in October 2010. Excluding tax effects, inflation measures only 2.6%, which is very close to the Central Bank's inflation target. Headline inflation now looks set to reach the inflation target by the end of this year. But the slack in the economy has also played a major role, as has cautious monetary policy relative to the circumstances. It is emphatically not a given that this progress should be made, and spare capacity in the economy does not produce price stability by itself, as innumerable examples illustrate, the most dramatic among them the runaway inflation in Germany's Weimar Republic and, more recently, Zimbabwe. It was therefore necessary to achieve exchange rate stability and bring inflation expectations down towards the target. This could not have happened if the Central Bank had complied with the wishes of those who went furthest in demanding a sudden, steep, and untimely interest rate cut. But in spite of all this, interest rates have fallen significantly. The Central Bank's effective policy rate has fallen from 18% (the seven-day collateralised lending rate) at the beginning of 2009 to the current 4½% (the average of the current account rate and the maximum CD rate), and is now at an all-time low in the nearly 50-year history of the Central Bank of Iceland.

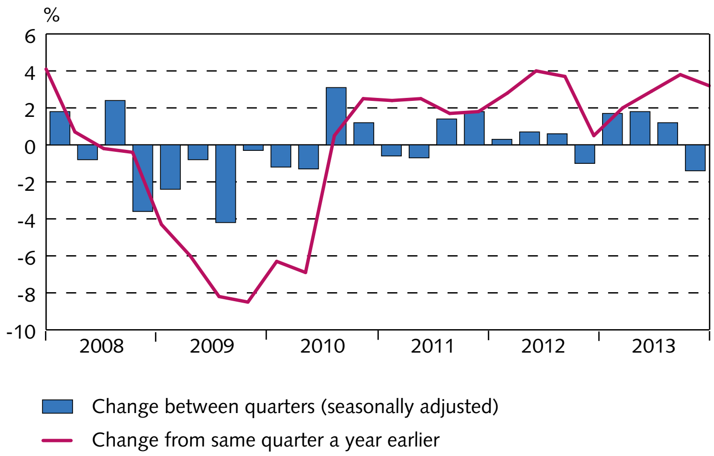
Progress has also been made in improving Iceland's external liquidity position by expanding the foreign exchange reserves, which reduces concerns about the Treasury's ability to service its foreign debt in coming years. Repurchases of the Treasury's foreign debt have also helped. The foreign exchange reserves exclusive of short-term obligations could quickly grow to over 3 billion euros, if Iceland draws in full on the loans contingent upon the third IMF review and when payments on the Avens agreement and the sale of Danish bank FIH are remitted. In comparison, the Icelandic Treasury's payments of instalments and interest on two bond series maturing in 2011 and 2012, less repurchases, amount to 1.1 billion euros.

This positive development explains the relatively upbeat outlook of foreign bankers and analysts towards Iceland, as could be discerned at the annual meetings of the IMF. It also explains why the CDS spread on sovereign debt has fallen in recent months and now lies below that of the European countries whose public debt problems have dominated business media recently. But we have to do better if Icelandic companies are to gain access to foreign credit markets on acceptable terms. Iceland's sovereign CDS spread is higher than the underlying fundamentals warrant, and positive developments in the next few months could make quite an impact on it. Credit rating agencies and others have given us a clear indication of which factors are most important: reducing uncertainty about domestic financial institutions, resolving the Icesave dispute, and demonstrating signs of economic recovery.

But where do we stand? Has the turnaround begun? According to the forecast published by the Central Bank last Wednesday, it has: seasonally adjusted GDP is projected to have grown between the second and third quarters of this year. This assumption is supported by various high-frequency indicators such as groceries turnover and payment card turnover. As the chart shows, we assume that this trend continued in the current quarter, although we expect growth to be somewhat less. In examining the chart, however, the viewer should bear in mind that quarterly GDP figures are quite volatile and measurements can show a small contraction in individual quarters, even though such a dip would not be considered to constitute an economic recession in the conventional sense.

Chart 1

Change in GDP



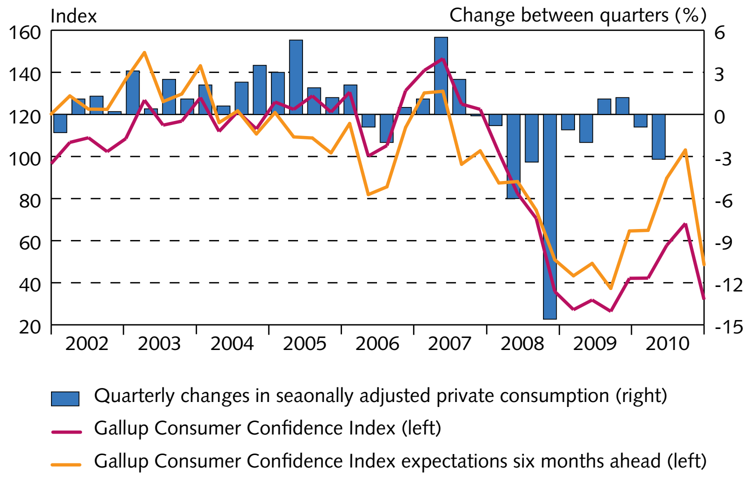
Sources: Statistics Iceland, Central Bank of Iceland.

But in connection with the economic outlook, it is important to remember that consumer confidence appears to have taken a bit of a dive in the past few weeks (see Chart 2), concurrent with the beginning of the legislative session in early October and the demonstrations that took place at the time. While one hopes that the situation will reverse quickly, this decline underlines the fragility of the recovery and the fact that the "attitudinal crisis" could have an unwarranted negative impact on economic developments in the months to come.

Chart 2

Private consumption and consumer confidence

Q1/2002 - Q4/2010[1]



1. Three-month average of Gallup Consumer Confidence Index. Value for Q4/2010 is for October. Figures for private consumption are only available until Q2/2010.

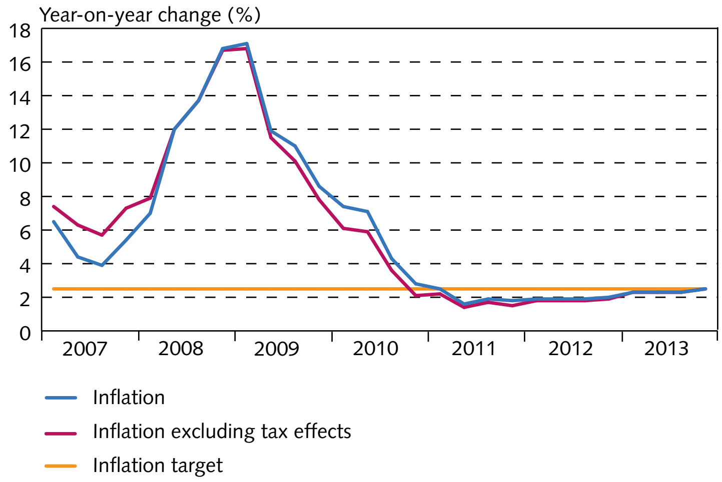
Sources: Capacent Gallup, Statistics Iceland.

According to the Central Bank's forecast, GDP will continue to grow in the medium term. It is expected to grow by around 2% year-on-year in 2011, 2.7% in 2012, and 3% in 2013. This will suffice to reduce unemployment beginning in Q2/2011, as unemployment generally begins to decline somewhat after output growth has begun to recover. Unemployment is forecast to taper off steadily throughout the forecast horizon, falling to 3% by 2013.

As I mentioned earlier, underlying inflation is already very close to target. According to the Bank's new baseline forecast, inflation will reach the target by the end of 2010. Due to the spare capacity in the economy and the expectation of further (albeit modest) appreciation of the króna, inflation will continue to subside, falling below 2% around mid-2011. It will then rise slowly and return to target towards the end of the current forecast horizon, which extends until Q4/2013 (see Chart 3).

Chart 3

Inflation



Sources: Statistics Iceland, Central Bank of Iceland.

But these are "only forecasts", as it were, and uncertainties are more numerous and more prominent than in the average year. External factors could change the scenario, but the authorities could also have either a positive or a negative effect on matters. The new Monetary Bulletin lists a variety of uncertainties. For example, output growth could be hindered by a number of factors: a setback in global recovery, further delays in the energy-intensive industrial projects that have been on the drawing board, or cutbacks in household consumption resulting from consumers' deciding to save more and improve their net asset position more quickly than in the baseline scenario. The negative effects of the last of these will subside over time, however, and in a small, open economy like Iceland's, the long-term effect should be positive. On the other hand, output could grow more than in the baseline forecast, particularly if risk premia on Icelandic financial assets decline significantly in the near future, foreign credit markets open up to Iceland again, foreign direct investment increases, and overall business investment becomes stronger.

But these are big "ifs." The roughly 3% output growth currently forecast for 2012 and 2013 is quite acceptable in the average economic climate. But projected growth for 2011 and 2012 is weak in view of the sizeable slack in the Icelandic economy. Furthermore, the foundations are not strong enough, as the contribution of external trade to output growth is negative and investment will be far below the historical average, even if it increases significantly from current levels.

According to the forecast, exports of goods and services will increase by a scant 1% in 2011, followed by 2% annual growth in 2012 and 2013, even though the real exchange rate will be notably below its historical average throughout the period.

Total investment will amount to just under 13½% of GDP in 2010, while business investment will be about 9%. Over the period 1980-2009, total investment averaged 22% of GDP, while business investment averaged 13% of GDP. This year's total investment ratio is the lowest since World War II. The ratio of business investment to GDP has been lower than in 2010, however: in 1945, in 1993-1995, and in 2009. Even in 2013, at the end of the forecast horizon, investment will be only about 18% of GDP, which is below the 20% needed to maintain 3% output growth in the long run.

This development in the level of investment is not inconsistent with the experience of other countries with a high pre-crisis investment ratio. Nonetheless, it is cause for some concern, and it is important to ensure that these will be "only forecasts", for nothing is inevitable in such matters. In speeches I have given in the recent past, I have emphasised that, although the interest rate level has certainly affected the investment level, it is probably far from being the most important determinant, particularly with interest rates as low as they are right now. I think other factors are much more influential, such as post-crisis risk aversion, uncertainty about demand and operating environment, reduced access to foreign credit, and impaired corporate balance sheets. These hurdles must be overcome, and they are one of the reasons that it is so important that progress be made in corporate debt restructuring.

But let us now turn to monetary policy. The Central Bank's interest rates have been lowered significantly over a short period of time, mostly because inflation has subsided rapidly and inflation expectations have followed suit. Interest rates had to fall accordingly in order to prevent the real interest rate from rising, which would have been quite unfortunate given the spare capacity in the economy. For the same reason, attempts have been made to lower real interest rates without jeopardising exchange rate stability and the inflation target.

As I mentioned earlier, Central Bank interest rates are at an all-time low. Nonetheless, the Monetary Policy Committee is of the opinion that there is still some room for further rate cuts if the króna remains stable and inflation continues to subside as forecast. The MPC emphasises, however, that the upcoming removal of capital controls creates uncertainty about just how much room there is to reduce interest rates. The breakeven inflation rate on Government bonds, as measured by the Central Bank, has declined since the 3 November interest rate decision, and the five-year breakeven rate is now broadly in line with the Bank's inflation target. Shorter-term expectations could fall even further in the near term, as the Bank's forecast projects that inflation will fall below 2% in 2011. Based on this measure, the effective real policy rate is now 2-2½%. This is below the pre-crisis equilibrium real interest rate, and probably lower than the rate that will prevail once the economy has normalised. But while we are at the bottom of the business cycle, it is appropriate that real interest rates should be well below long-term levels. Nonetheless, it is clear that, as interest rates fall, there will be less scope for further rate cuts. At present, however, I think we have not reached the bottom of the interest rate cycle.

Let us turn now to the capital controls. When we begin to lift controls on capital outflows, sometime after March 2011, the exchange rate will lose the support the controls have provided. If all of the capital controls were lifted today, the exchange rate would probably fall sharply. But no such plan is in the offing. On the contrary: work will be done to create the conditions for removal of the controls without necessarily causing a marked drop in the exchange rate.

The liberalisation strategy publicised in August 2009 specified three conditions for removal of the controls: 1) macroeconomic stability, including credible measures to ensure fiscal sustainability and declining inflation; 2) a sound financial system; 3) sufficient foreign exchange reserves. The financial system soundness requirement has not yet been met, but the other two are relatively well in place. But why were these conditions chosen? They were chosen because they are essential if risk premia on Icelandic financial assets are to fall to any significant degree. In general, the lower such risk premia are, the greater the interest rate differential with abroad, and the lower the exchange rate is, the more favourable the conditions for lifting controls of this type. This is because the exchange rate is supported by a larger risk-adjusted interest rate differential and expectations of currency appreciation are more likely to outweigh expectations of depreciation. In my opinion, all of the conditions for a marked decline in risk premia should be in place in the next few months. Inflation will also fall somewhat further in the near future. Consequently, I am of the opinion that plans to lift the capital controls do not change the fact that there is still some room for further reduction of interest rates.

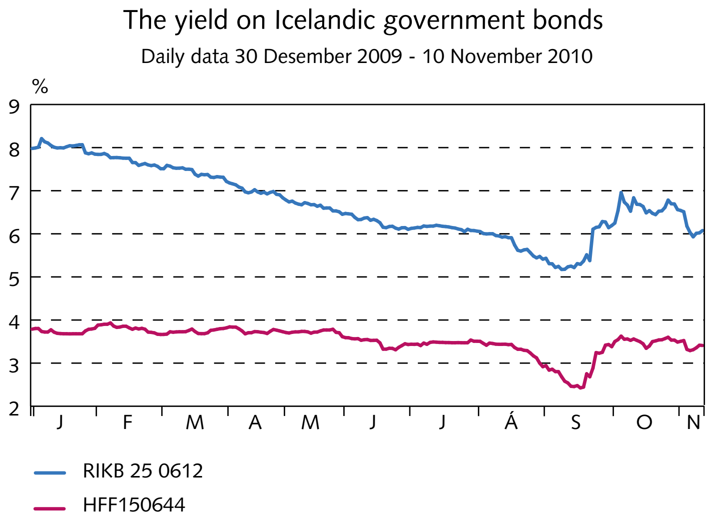
Last Wednesday, in connection with the Bank's interest rate announcement, I issued a statement on the capital controls. There is no reason to repeat it in full here, as it is available on the internet, but the thrust of it is that no broad-based steps will be taken to lift controls on capital outflows until March 2011 at the earliest, and before that is done, a revised financial account liberalisation strategy will be publicised. The intervening months will be used to lay the foundations for potential liberalisation. To all appearances, the statement was well received, and bond market yields fell markedly thereafter.

As I said at the beginning of my speech today, monetary policy implementation is unusually complex at present. This is equally true of monetary policy communication, the presentation and explanation of monetary policy. Monetary policy communication is simpler when it is possible to ignore the exchange rate apart from its effect on inflation, but an imminent systemic change such as financial account liberalisation adds to the complexity. Yet it is important to realise that the problems inherent in such a systemic change will be solved only to a limited degree with improved communication. The uncertainty is real, and the Central Bank cannot create more certainty than it faces itself. Experience shows as well that the market can get ahead of itself even if monetary policy communication is in good order.

A number of factors indicate that, to some extent, the market misunderstood the Monetary Policy Committee's August statement. We must learn from such occurrences, of course, and try to do better in the future. Some appear to have interpreted that statement to mean that plans to lift the capital controls have been abandoned temporarily – even for a period of years – and that this is why interest rates were lowered as much as they were. But to my mind the interest rate cut had more to do with rapidly declining inflation than increased uncertainty about financial account liberalisation, although such uncertainty did of course exist. The statement was made before the September Supreme Court judgment on exchange rate-linked loans and before it came certain that the third review of the IMF programme was not going to be unduly delayed. The court judgments and IMF review were in place by the MPC's September meeting, however, and as a result, the substance of the September statement was different as regards the conditions for liberalisation. But it was conditions that had changed, not the policy.

As the chart shows, developments in Government bond yields in August and September have a bubble like pattern that is often described as going down the stairs and coming up on the lift (or vice versa, if one considers price rather than yield). It is likely, then, that factors in addition to the MPC statements were at work here. These could include unusually large leveraged positions, the structure and effectiveness of the market, and a typical bubble phenomenon featuring extreme tension right before the bubble bursts. For its part, the Central Bank will investigate what happened and draw the appropriate lessons from it. But this could be useful for others as well. At all events, if market participants are interested in leveraged speculation on the duration of the capital controls, they are free to engage in it. But if they do, it is their choice and their responsibility. The removal of the capital controls is certainly further off than many observers thought earlier this fall, but a delay of several years is not in line with announced intentions.

Chart 4



Source: Central Bank of Iceland.

In closing, I wish to say this: A great deal of progress has been made towards establishing stability, and monetary policy has played a large role in that process. At present, the task at hand is to create a strong foundation for lasting output growth and reconnect Iceland to the global capital markets. Monetary policy will have less of a role in these matters, but the Central Bank will have a sizeable role in restoring Iceland's connection with global markets. This applies both to participating in entering foreign credit markets and to formulating a regulatory framework for more prudent external financial relations than Iceland had before the crisis. But that is a subject for another occasion.

Thank you.