Summary — 11 proposals from the task force on monetary policy reform

The task force has presented a total of 11 proposals that address four principal areas of monetary policy. The task force has benefited from advice from foreign experts and from the International Monetary Fund (IMF) in formulating its own proposals, which are, of course, the responsibility of the task force itself.

- ✓ Three of the proposals centre on the framework for prudential tools, to ensure coordination between financial stability and monetary policy. The role and responsibility of the Central Bank is expanded, but alongside this increased authority, it is ensured that the Central Bank's responsibility and management processes in the areas of monetary policy and financial stability will be strengthened.
- ✓ Two proposals for an improved inflation target ensure that the Bank will apply its policy interest rate in a more effective manner without compromising financial stability.
- ✓ Two of the proposals centre on more targeted application of the Bank's policy instruments. They ensure clearer boundaries between monetary policy instruments, on the one hand, and financial stability instruments, on the other.
- ✓ Four of the proposals centre on the monetary policy decision-making process and contribute to greater transparency and increased discussion of monetary policy, with the aim of creating a more broad-based public consensus on monetary policy and financial stability.

Three proposed reforms to the framework for macroprudential and monetary policy

The application of macroprudential tools centres not only on maintaining financial stability — this new way of thinking and/or methodology can also hone monetary policy by curbing credit growth and levarege in the economy. This has particular significance for small currency areas where a widening foreign interest rate differential can cause balance of payments problems and create the risk of financial and economic instability. These problems lie not only in foreign exchange market instability, but also in inflows of foreign capital into the financial system, causing credit and asset price bubbles.

The understanding is now gaining currency that, because of the globalisation of capital transactions, independent monetary policy is not truly an option for smaller currency areas unless it is possible to manage the capital account, directly or indirectly, irrespective of the exchange rate regime in place. This can be done with capital controls, but it can also be accomplished with appropriate application of macroprudential tools. Macroprudential tools can create a stronger foundation for independent monetary policy in small, open economies by improving the transmission of monetary policy to the real economy via the so-called credit channel. This would accomplish the task that capital controls were designed to carry out, but at much less cost to the nation.

In the task force's opinion, it is vital to designate one party that is responsible for applying macroprudential policy and maintaining financial stability. Furthermore, it is important that the institutional framework contribute to improved coordination in the implementation of macroeconomic policy and conventional monetary policy. Moreover, it is important that the limited human resources in our small country be utilised as efficiently as possible in analysing and collecting information. The current macroprudential framework dates from 2014 and was intended at that time to be only a temporary step, until the Central Bank assumed sole responsibility for macroprudential policy. The time has come to take that step.

At the task force's request, Kristin Forbes has reviewed the application of macroprudential policy for Iceland. Her conclusions are outlined in her report. In Kristin Forbes' opinion, Iceland is well advanced vis-à-vis other countries as regards macroprudential policy. However, she recommends significant changes to the formal economic policy framework — changes that the task force wishes to include in its proposal, which is actually in line with the opinion of other foreign consultants that have addressed this issue previously.

Proposal 1: The Central Bank of Iceland shall be solely responsible for macroprudential and microprudential policy and shall have oversight of analysis, decision-making, and application of all macroprudential tools. Prudential supervision shall be transferred in its entirety to the Central Bank.

The proposal above entails placing all macroprudential and microprudential policy under the aegis of one institution, the Central Bank of Iceland. Responsibility for this will therefore be transferred from the Financial Supervisory Authority to the Central Bank, and the division of tasks between these two institutions will be clearer. This change will increase the weight of financial stability in the Central Bank's activities. The Financial Supervisory Authority will remain the supervisor of the financial markets.

Placing all prudential tools in one institution will make the entire process, from analysis to decision-making, more efficient. Analysis, decision-making, and responsibility are all with the Central Bank. Furthermore, analysis work will be stronger and broader with information and specialised staff in the same place.

Concurrently, the Central Bank's responsibility and management role must be strengthened with the appointment of a separate Deputy Governor who will focus on macroprudential policy. In addition, another Deputy Governor will focus on monetary policy. It is assumed that there will still be one Governor, who will be the most senior official at the Bank and will be responsible for its operations. These three, however, will create a multi-member authority. This does not entail, however, a return to the previous structure, with three governors of equal stature, for according to the old adage, there can only be one captain on each ship. On the other hand, there are various decisions pertaining, for example, to discretionary policy that would be best placed in the hands of a multi-member authority. This refers in particular to communications with financial institutions, such as for lending of last resort, or decisions on market intervention falling outside the scope of rule based economic policy.

Proposal 2: Two Deputy Governors shall be appointed, one to focus on financial stability and the other to focus on conventional monetary policy. Both of them will be members of the Board of Governors, together with the current Governor. The Board of Governors shall constitute a multi-member authority that will take decisions on matters relating to discretionary policy.

The division of tasks will be as follows:

1. Governor The Bank's highest-ranking official — a CEO of sorts. The Governor is also the chair of the Board of Governors, is responsible for the Bank's operations, and is the representative of the Bank and the Board of Governors. Is a member of the Monetary Policy Committee, the Systemic Risk Committee, and the Financial Stability Committee.
2. Deputy Governor for monetary policy: Oversees monetary policy. Is a member of the Monetary Policy Committee and the Systemic Risk Committee.
3. Deputy Governor for financial stability: Oversees macroprudential and microprudential tools. Is a member of the Monetary Policy Committee, the Systemic Risk Committee, and the Financial Stability Committee.

Concurrent with this changed role of the Central Bank and the increased responsibility for financial stability, it is also important to clarify the division of tasks among committees, and to ensure cooperation and synergy between monetary policy and macroprudential policy. The task force makes the following proposal.

Proposal 3: The number of external members of the Financial Stability Committee shall be increased, and the Committee shall take final decisions on the application of all macroprudential tools.

It is recommended that the Financial Stability Council be replaced with a Financial Stability Committee, with both the Governor of the Central Bank and the Minister of Finance and Economic Affairs acting as chairpersons. The Committee will also include the Deputy Governor for financial stability and two external members, at least one of whom must have experience in the financial world. It is recommended that voting on the application of macroprudential tools take place within the Financial Stability Committee and be made public when changes in policy instruments are announced. Final decisions on the application of prudential tools shall therefore be in the hands of the Financial Stability Committee. The Systemic Risk Committee will continue to oversee analytical work, present proposals on the implementation of prudential tools to the Financial Stability Committee, and oversee the implementation process.

Two proposals on changes to the Central Bank's inflation target

During the years prior to the financial crisis, there was debate about what role monetary policy should have vis-à-vis asset prices — or, more precisely, bubble formation in asset markets. This debate was often accompanied by the term "lean or clean" — i.e., whether central banks should lean into the wind and raise interest rates to push against rising asset prices or leave the asset markets alone and focus only on cleaning up after bubbles have burst.

This debate has subsided over the years, however. Instead, a consensus appears to be developing that interest rates are relatively toothless against financial bubbles. It has been said that an interest rate level that would suffice to curb an asset bubble would be so high that it would paralyse the real economy and therefore be enormously costly. By the same token, such a steep rise in interest rates would cause severe problems in the foreign exchange market, with an overly high real exchange rate and a current account deficit, which would certainly undermine financial stability.

The discussion above on the division of tasks centring on macroprudential policy, on the one hand, and monetary policy, on the other, concurrent with increased emphasis on financial stability, is of considerable importance for the Central Bank of Iceland, particularly in view of Icelanders' bitter experience of the 2008 financial crisis.

The current cooperation agreement between the Government and the Central Bank, dated 27 March 2001, assumes that the inflation target will always take priority over financial stability. Given the social costs associated with financial instability, financial stability must be given priority over price stability if such circumstances develop. Furthermore, the maintenance of financial stability must set certain boundaries on monetary policy implementation. As a result, the task force recommends the following changes.

> **Proposal 4:** The cooperation agreement between the Government and the Central Bank of Iceland shall be amended so that the maintenance of financial stability will take priority over the maintenance of price stability if circumstances develop so that the former is in jeopardy. In such instances, the Monetary Policy Committee shall allow inflation above target so as to give the Financial Stability Committee the scope needed to apply macroprudential policy.

In Iceland, over a fourth of the consumer price index is attributable to house prices. This can cause a detrimental overlap between price stability objectives and financial stability objectives. This is not only because the Bank must apply interest rates to control house prices, which account for 25% of the Bank's inflation target, but also because the Bank's interest rates have a very limited impact on house prices, as transmission of the policy rate to long-term indexed interest rates is extremely weak in Iceland, and statistically insignificant. Statistics Iceland also estimates housing costs in the CPI, by using the so-called user cost method, which is based on a three-month moving average of house prices. Given the wide fluctuations in real estate prices in recent years, this method of measurement causes short-term fluctuations in inflation that the Central Bank is required by law to address.

It is emphasised here, however, that the independence of Statistics Iceland is as important as the independence of the Central Bank. It is important that measurements of inflation be as credible and accurate as possible. The task force therefore does not take a position on which method of measurement gives the most accurate view of housing costs, and it is clear that there are very strong theoretical arguments in favour of Statistics Iceland's current method. At the same time, this method of measuring housing costs makes the CPI a very unfortunate criterion for the inflation target, as short-term fluctuations in house prices are transmitted to inflation with a time lag and the transmission of the Central Bank's policy rate to long-term mortgage rates is very weak. Applying monetary policy in a manner that addresses these fluctuations in housing costs — such as by trying to bring about a reduction in import prices with a higher exchange rate — creates the risk of extremely a high sacrifice cost associated with the choice between price stability, on the one hand, and output, on the other.

In this context, the task force takes the basic position that house prices do not belong in the Central Bank of Iceland's inflation target. There are several ways to accomplish this: the Bank could use a different index, such as the CPI excluding housing or the Harmonised Index of Consumer Prices (HICP). The task force is of the view that such options should be explored thoroughly.

> **Proposal 5:** The Central Bank's inflation target shall remain 2.5%, but the price index to which the target applies shall not be based on the cost of owner-occupied housing. The inflation target shall therefore explicitly exclude house prices.

Two of the proposals centring on more targeted application of policy instruments

Since the 2008 crash, foreign exchange market intervention has played a major role in monetary policy implementation. This was particularly the case in 2014-2016, when the Bank's purchases accounted for 50-70% of total market turnover, although intervention has been almost non-existent since 2017. It is clear that market intervention will continue to play a large role in Icelandic monetary policy in the future, in the attempt to ensure price stability, as monetary policy transmission takes place to a large degree through the foreign exchange

The task force engaged Sebastian Edwards to focus in particular on the Bank's intervention in the foreign exchange market in a report entitled *Monetary Policy in Iceland: An evaluation*. He recommends that a so-called "traffic light system" like that used by the Reserve Bank of New Zealand (RBNZ) be used as a basis for the Central Bank's intervention policy. The task force recommends that the Central Bank adopt the traffic light system used by the RBNZ, in accordance with Sebastian Edwards' recommendation. This also entails that the Bank will publish its estimate of the equilibrium real exchange rate concurrent with its macroeconomic forecasts.

Proposal 6: The Central Bank of Iceland shall use the RBNZ's traffic light system to create clear ground rules for decision-making and communication of information on foreign exchange market intervention. Furthermore, there is need for a clearer and more transparent sterilisation policy in connection with intervention. Furthermore, the Bank shall publish its assessment of the equilibrium real exchange rate on a regular basis.

The above-mentioned traffic light system is very general, of course — a more detailed framework will doubtless be developed based on practical experience. It should create a set of ground rules for intervention, however, which have not been in place heretofore. This will create a framework for decisions made by the Monetary Policy Committee and will better enable the Bank to explain its policies and decisions to market agents and the general public alike. Furthermore, this should give the three commercial banks, which constitute the interbank foreign exchange market, the scope to create enhanced short-term stability in the market through smoother price formation. It is important as well to bear in mind that such an intervention policy cannot entail a fixed exchange rate policy, a pledge that the Central Bank of Iceland will use its reserves to maintain a given exchange rate, nor can it be expected that foreign exchange market intervention will have a long-term impact on the exchange rate of the króna.

In June 2016, special restrictions were imposed on capital inflows. It was said that the purpose of these restrictions was to combat "excessive inflows of capital" that could lead to the accumulation of systemic risk in the economy. The Central Bank has also explained the origins of the restrictions as a response to disturbances in the transmission of the policy rate caused by inflows of foreign capital. In the IMF's June 2017 report on Iceland, it is strongly recommended that the 40% special reserve requirement be lowered to zero, as it cannot be seen that conditions actually called for its use. Sebastian Edwards and Kristin Forbes concur with the IMF's opinion that under current conditions, the grounds for restrictions on inflows are weak, as before they were imposed, the scale of the inflows was not large enough to have undermined financial stability and that such a risk could have been averted with other types of macroprudential tools.

Moreover, Kristin Forbes mentions three conditions that shall always be considered before imposing inflow restrictions:

1. When economic imbalances have developed, when the króna is priced too high, and it is not possible to use other macroprudential tools to address such an imbalance.
2. Inflow restrictions are then imposed as a temporary measure if the impact of other policy instruments will be lagged.
3. When capital inflows jeopardise financial stability.

The fact is that restrictions on international trade are a very clumsy tool that do damage when applied. The imposition of restriction must be regarded as the last line of defence — or last-resort economic policy. It is difficult to conclude otherwise than that the current use of inflow restrictions runs counter to expert advice and that the restrictions are imposed primarily to strengthen monetary policy implementation along the interest rate channel.

That being the case, the task force wishes to emphasise that the inflow restrictions are not a monetary policy tool but a macroprudential tool to ensure financial stability. Decisions on the application of such tools should be in the hands of a Financial Stability Committee, together with other decisions on the use of macroprudential tools. Although inflow restrictions will continue to be part of the Central Bank's policy instruments, it is important that there be clear rules governing when they are deployed.

Proposal 7: Inflow restrictions shall be within the purview of the Financial Stability Committee and part of macroprudential policy, and shall be lifted in stages. For the future, clear rules shall govern when they are imposed.

Four proposals for a more efficient decision-making process

Even though the change that took place with the new Central Bank Act in 2009, when the Monetary Policy Committee was entrusted with taking interest rate decisions, was a significant step forwards, it is also clear that the Committee's transmission of interest rate expectations is not optimal. It can be seen in the bond market response following the Bank's interest rate decision dates: the Bank's decisions constantly appear to take the market by surprise, which means that the decisions are at odds with the expectations that had developed beforehand. For example, fluctuations in market yields in Iceland on interest rate decision dates are as much as three times those in Sweden and twice as much as those in Norway. This indicates a need to manage expectations more effectively, enhance the transparency of interest rate decisions, and give more effective forward guidance on interest rate setting.

One way the Central Bank could improve the management of expectations would be to have the Bank's Economics Department publish the interest rate forecast paths underlying its inflation forecasts. The department did this in 2007 and 2008, with good results.

The theory behind this is not unequivocal, however. The policy rate forecast is prepared by the Bank's Economics and Monetary Policy Department, but another party — the multi-member Monetary Policy Committee — takes decisions on interest rates themselves. Each member of that Committee is there on his or her own premises and expertise — and is expressly expected to take independent decisions based on forecasts prepared by the Central Bank itself. Therefore, in no way can the policy rate forecast oblige the Monetary Policy Committee. In the task force's view, the publication of a policy rate path could potentially enhance the credibility of the inflation target by showing the Bank's interest rate response to inflation further ahead — as well as managing market expectations more effectively.

The task force considers it important, however, that in order to improve management of expectations, the discussion should be directed more at the future with the publication of the Central Bank Economics Department's policy rate forecasts.

Proposal 8: The Central Bank shall publish the policy rate path in *Monetary Bulletin* four times a year. In this way, it will be possible to strengthen market expectations and enhance transparency of the Bank's long-term interest rate policy.

In this environment, it will be necessary to strengthen the Monetary Policy Committee's operational framework. At present, the external members of the Committee receive relatively little professional support from the Bank, as they have no direct access to Bank staff, nor do they have their own employee to assist them with analysis or verify their own conclusions. Furthermore, external members are paid relatively little for their work, although they have relatively limited duties, which entail attending informational and presentation meetings with Bank staff on the days prior to interest rate decisions.

The purpose of appointing external members in the first place is to apply some sort of checks and balances to the Central Bank and provide for the expression of counterarguments to opinion that may have become institutionalised within the Bank. For instance, it is also true that external members do not publicise the grounds for their votes after each interest rate decision. Anything relating to the Monetary Policy Committee's interest rate decisions has informational value for market agents, households, and businesses. In this context, it would be positive that the voices and opinions of external members should also be heard — so that parties outside gain a more accurate feeling for which points are debated within the Committee — and which factors are important at any given time.

In view of this, the task force considers it important to expand external Monetary Policy Committee members' responsibilities and provide them with better support, which is in line with the practice of other foreign central banks that have external Monetary Policy Committee members. Furthermore, the Committee is advised to give more consideration to forward guidance, particularly so-called Delphic forward guidance. In providing Delphic forward guidance, a central bank gives indications concerning developments in short-term interest rates, depending on how certain economic variables develop. This has been done by the Monetary Policy Committee to good effect in connection with negotiation of wage agreements, and it is therefore possible to build on that success.

Proposal 9: The responsibilities of and support given to external Monetary Policy Committee members needs to be increased. Decision-making should be made more transparent with the publication of individual members' votes at the time of the decision. The Committee should give increased consideration to Delphic forward guidance in connection with interest rates.

Transparency is the foundation of an inflation target; it is the premise for evaluating a central bank according to the work it does; and it is the basis for professional and fair discussion of monetary policy objectives and options. For example, the public should be able to understand the short-term tradeoffs inflation versus unemployment, and why painful measures must sometimes be taken to ensure price stability. This means that central banks must speak directly to the public so that their objectives will be achieved. It is very important to follow up on the success that has been achieved in enforcing the inflation target. It is clear that the price stability of the past 4-5 years has delivered enormous benefit to the public through increased purchasing power — and it is important that this be valued appropriately. In addition, a greater public consensus on the policy is needed.

In the task force's opinion, the Central Bank of Iceland has not carried out its educational role well enough as regards either monetary policy in general or the Bank's role. That said, it is acknowledged that the past few years have been unusually busy and complex. As the old adage says: *It may have been necessary then, but it is imperative now.*

Proposal 10: The Central Bank shall contribute to increased information on monetary policy and the value of the inflation target, with the aim of enhancing the general public's understanding of the possibilities available and the limitations in place, and with the objective of contribute to greater consensus on policy.

The current external review is the first of its type. Most foreign central banks have such a review carried out on a regular basis, however. Regular reviews of monetary policy provide central banks with professional oversight and should generate healthy discussion of monetary policy in general, if not creating a general consensus on the framework and conduct of monetary policy. Furthermore, regular reviews of monetary policy ensure that the pros and cons of the framework as current at any given time will be evaluated.

Proposal 11: A regular external review of monetary policy shall take place every five years. Such a review is conducive to greater harmony and support for monetary policy conduct, as well as providing the Bank with professional oversight.