

MONETARY POLICY IN ICELAND:
AN EVALUATION

by

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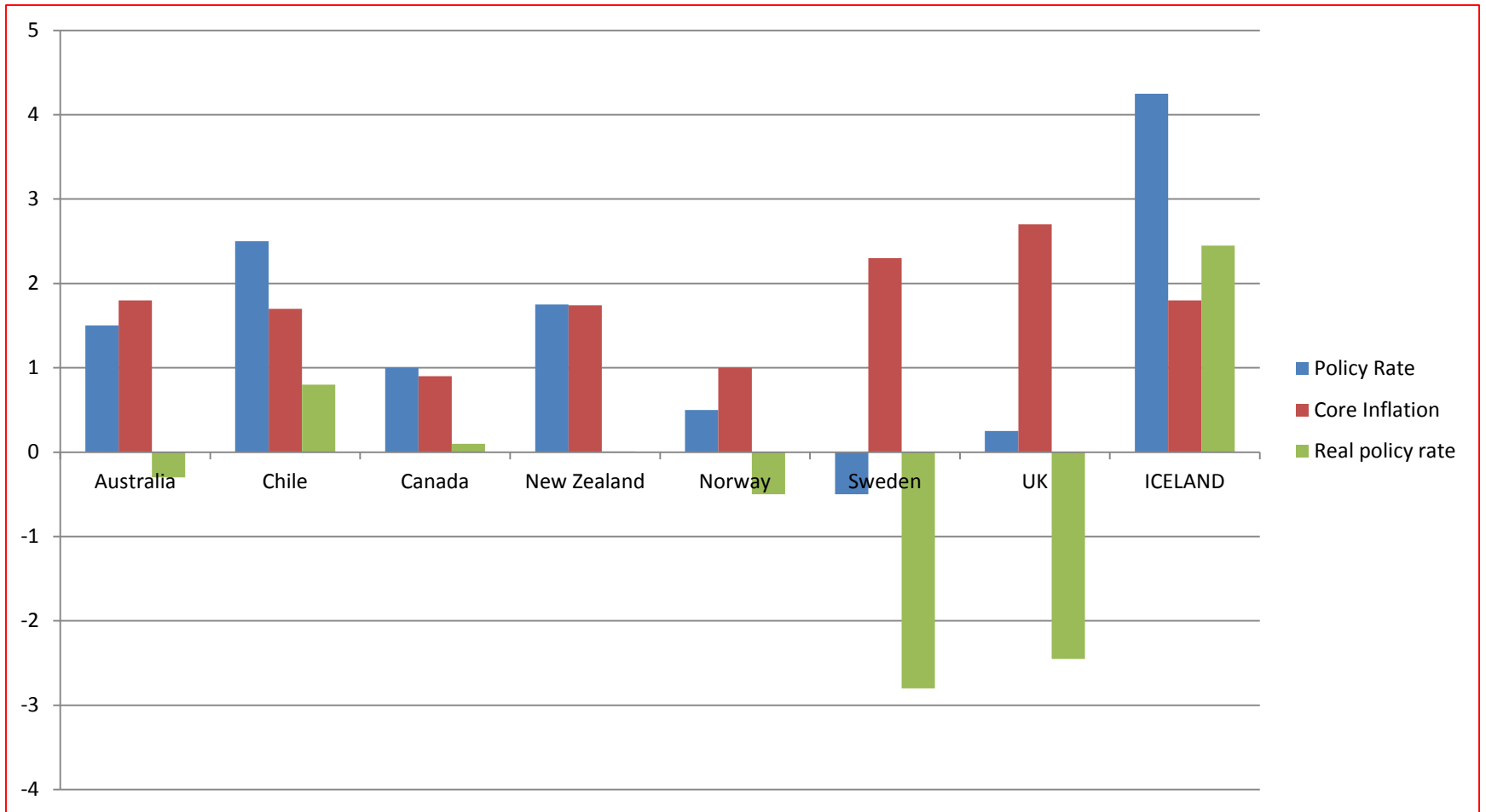
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Introduction



PART ONE: MONETARY POLICY OPTIONS: REFLECTIONS BASED ON ICELAND

- *Dilemmas, trilemmas and all of that*
- *Credibility vs. flexibility*
- *Does flexibility really means having a shock absorber?*
- *The transmission mechanisms of monetary policy under flexible exchange rates*
- *Do flexible rates buy full monetary policy independence?*
- *Capital controls and monetary policy*
- *Currency intervention*
- *Monetary regimes, monetary policy, fiscal policy and labor markets*

Monetary policy independence

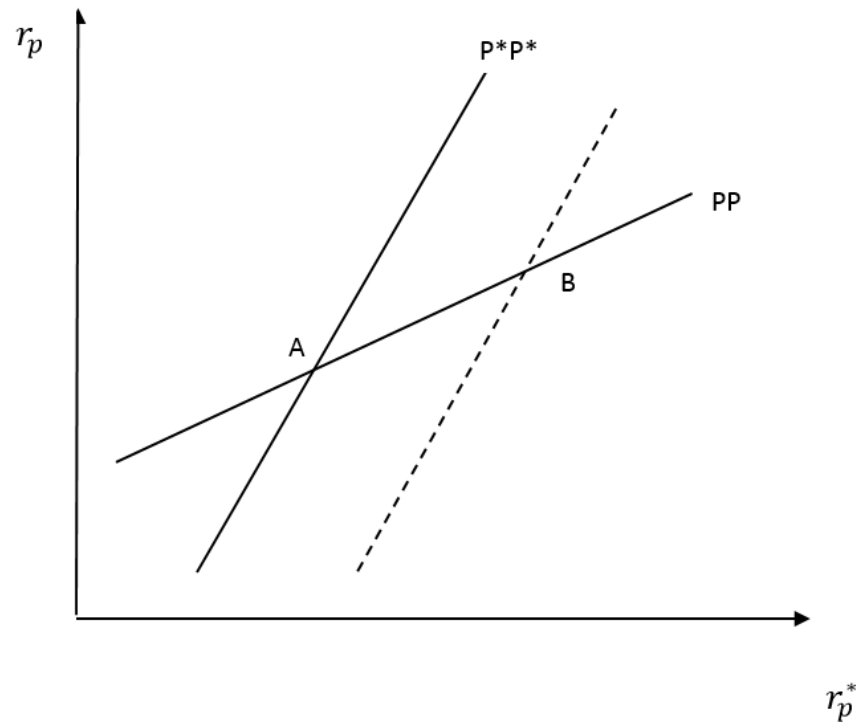


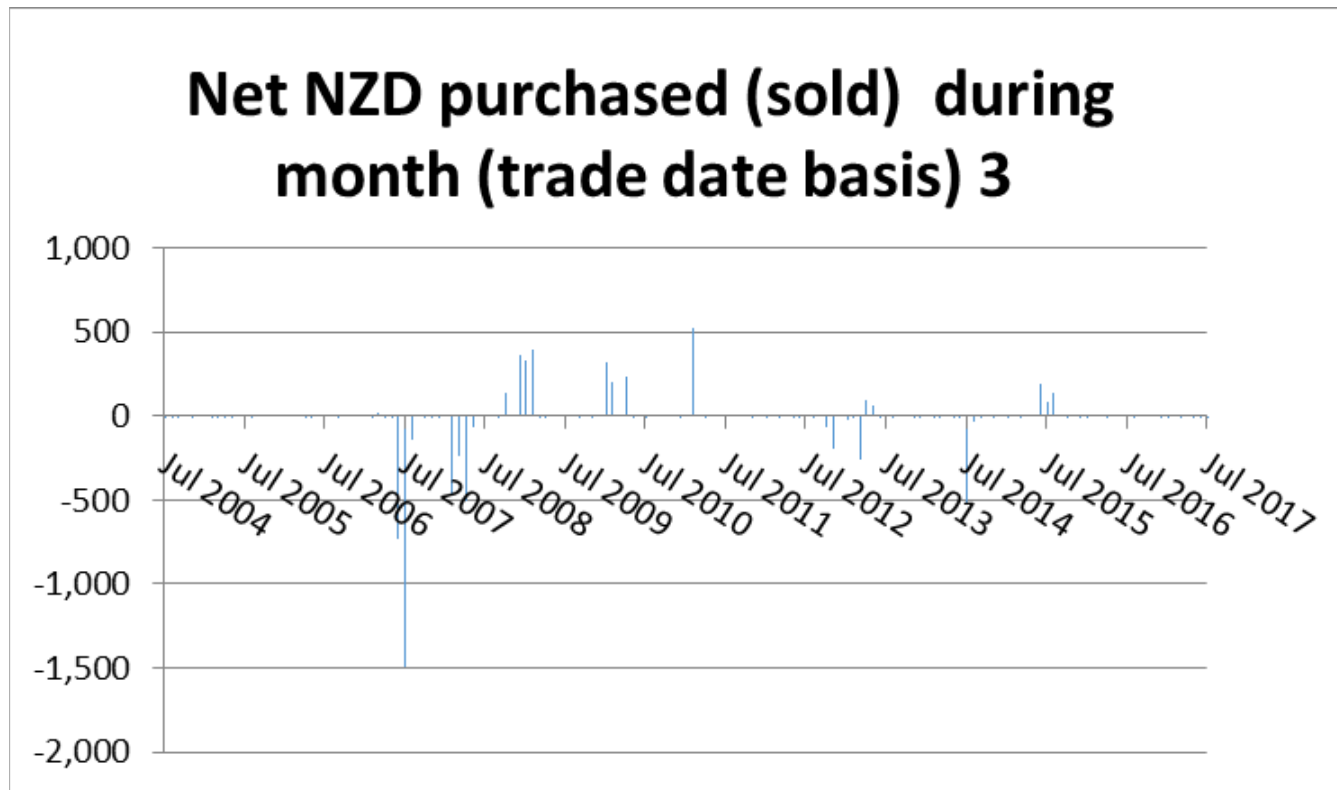
Figure 2: Policy rates equilibrium under "policy spillover" and large countries

Controls on inflows with intervention: Chile, 1991-1999

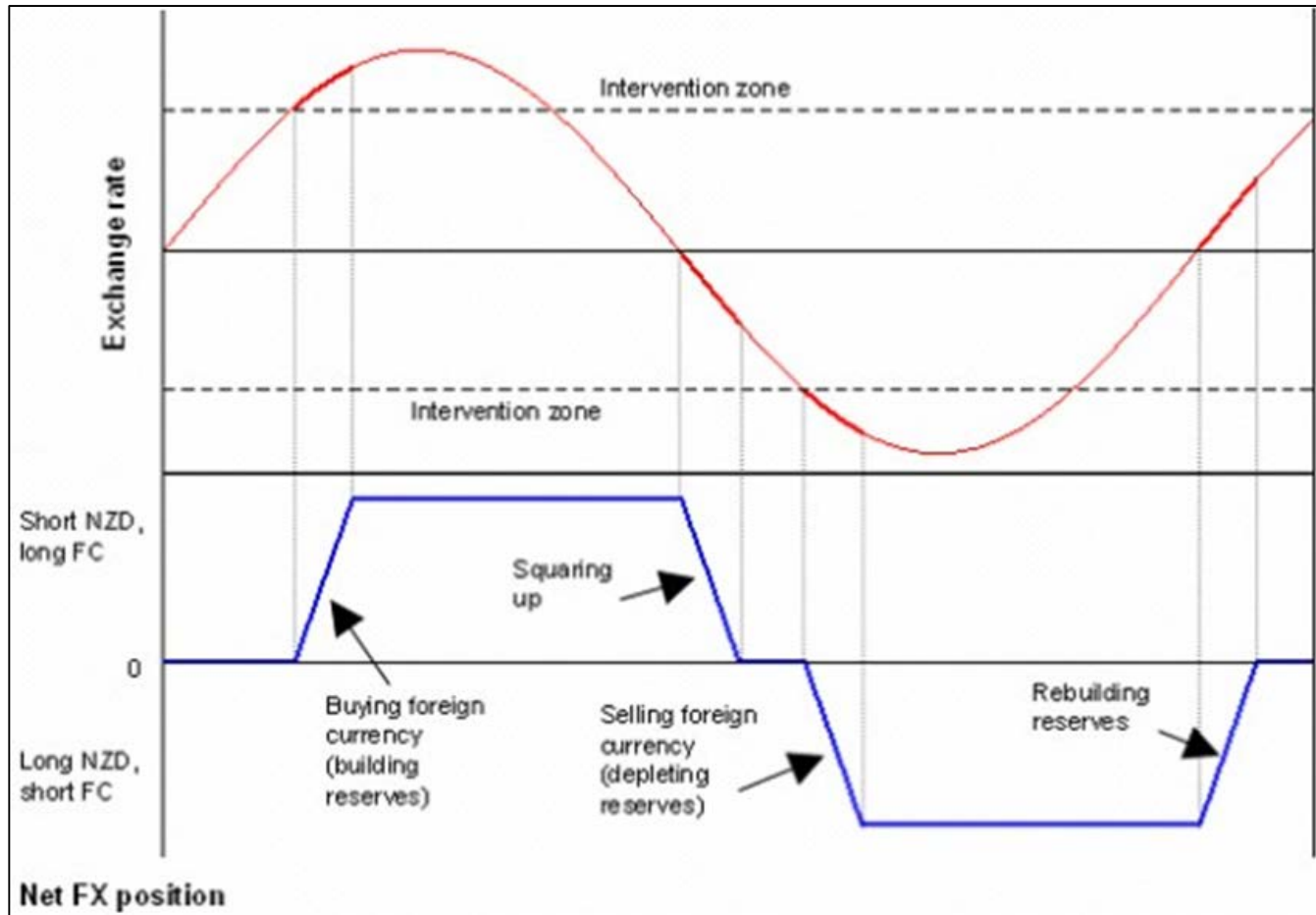


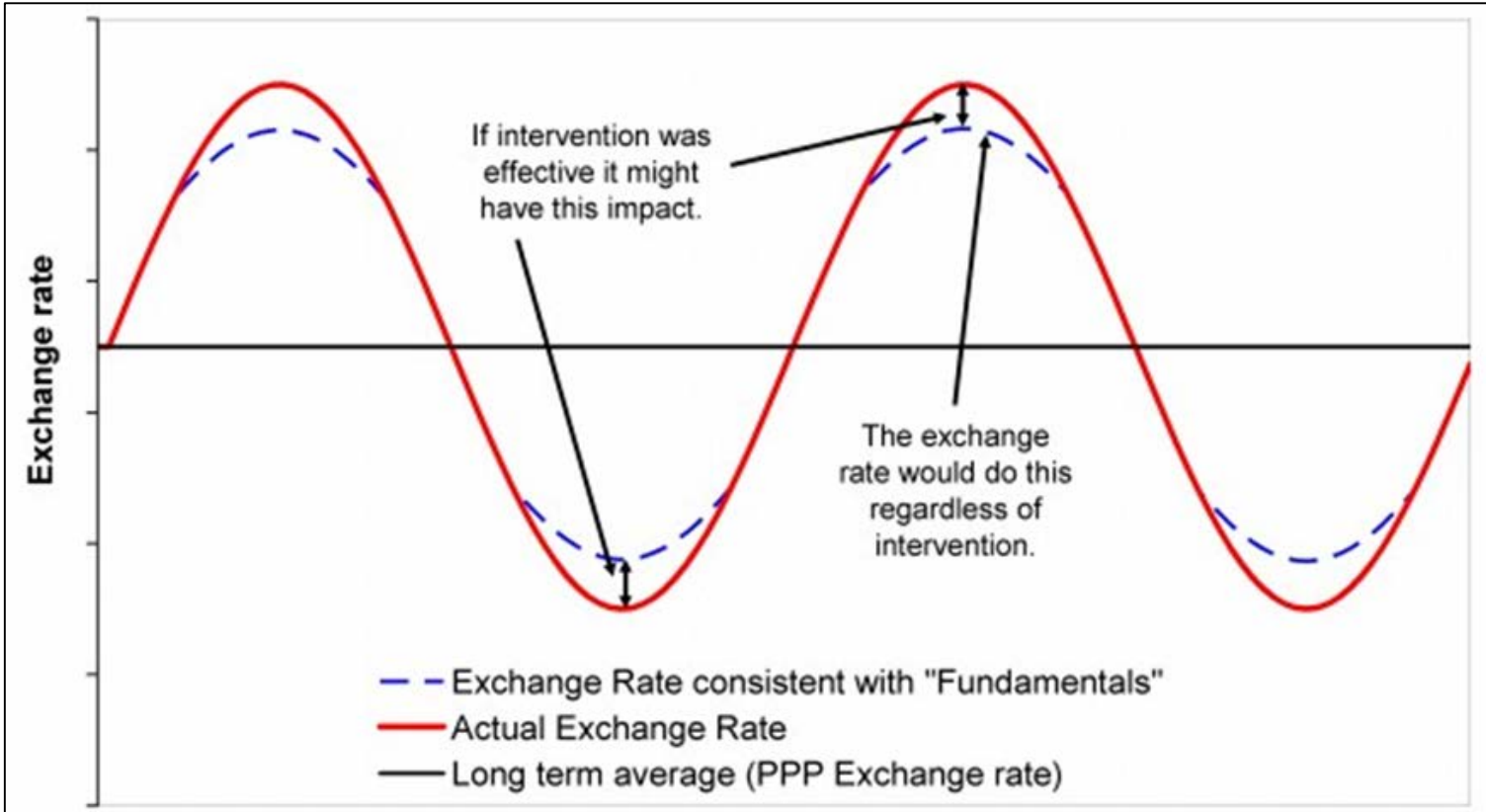
Fig. 2. Exchange rate and exchange rate bands. All exchange rates measured in logs.

Foreign exchange market intervention, New Zealand, 2004-2017



Currency intervention model, New Zealand



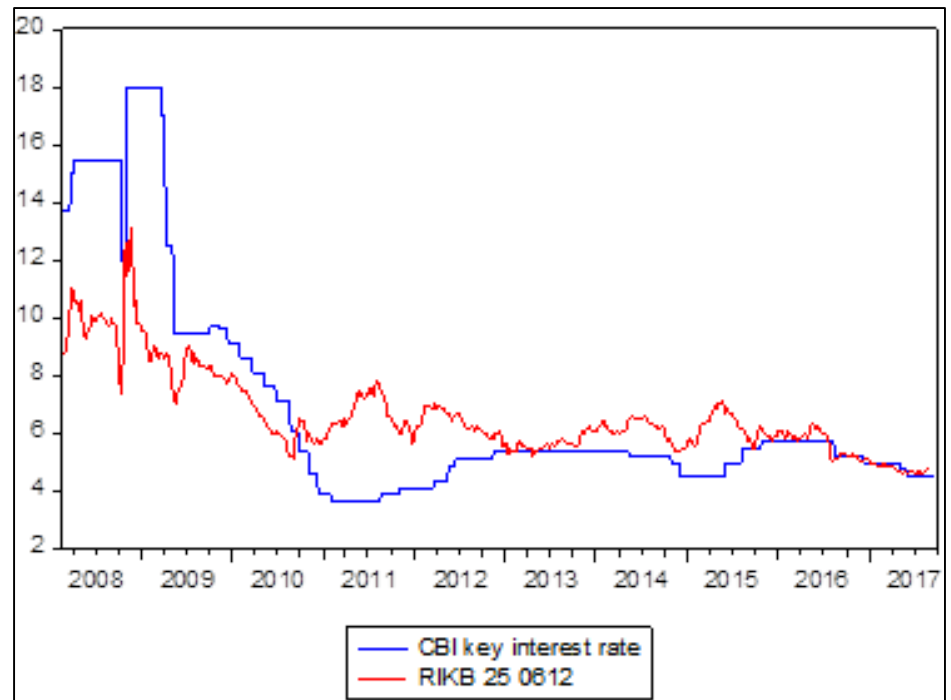


PART TWO: AN ASSESSMENT OF CURRENT MONETARY POLICY IN ICELAND

- “Inflation has been *at or below* the Central Banks inflation target for over three years... Increased price stability has been achieved in spite of considerable domestic inflationary pressures stemming from large pay increases, and this stability is due in no small part to a steep decline in import prices, which in turn is due to domestic inflation and the appreciation of the *króna*.”
- “As inflation has fallen in recent years, it has also grown less volatile.”
- “Deviations from the inflation target have also diminished greatly.”
- “Short- and long-term *inflation expectations have gradually subsided* to the targets and have become less volatile.”
- “Inflation appears to be less persistent than before.”
- “The inflation target has gained credibility.”
- “Business cycle fluctuations have diminished.”
- “Fluctuations in the exchange would have diminished... and there are signs that their characteristics have changed in recent years.”
- “Exchange rate movement seemed increasingly to counteract the effects of aggregate supply and demand shocks.”
- “Fluctuations in real interest rates have diminished as inflation expectations have become more firmly anchored.”

Transmission mechanisms

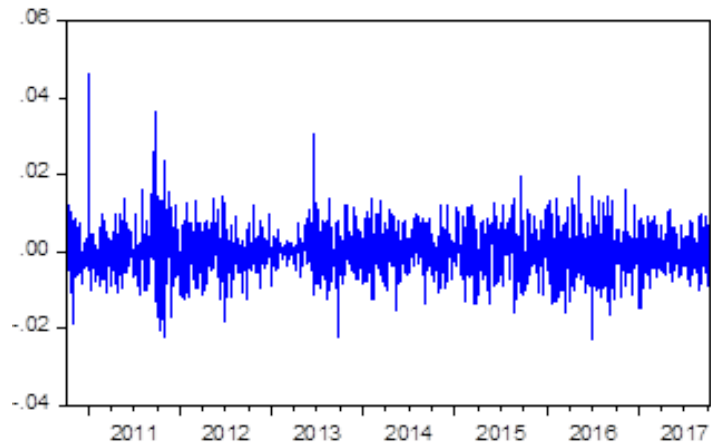
- Is it the yield curve?
- Is it the exchange rate?



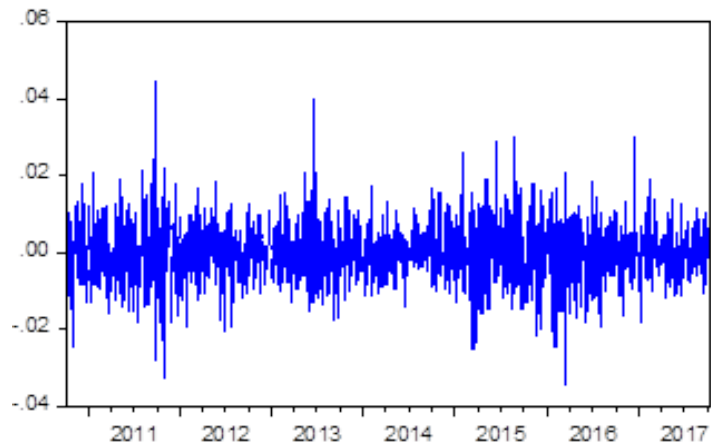
- Monetary policy and the yield curve
- Monetary policy and the exchange rate
- Exchange rates and pass-through
- Monetary policy and the housing sector
- Taylor rules for a small open economy
- Assessing the long term equilibrium value of the real exchange rate, the sustainable current account balance, and sustainable NIIP
- The effectiveness of capital controls and currency intervention

Bilateral exchange rate volatility

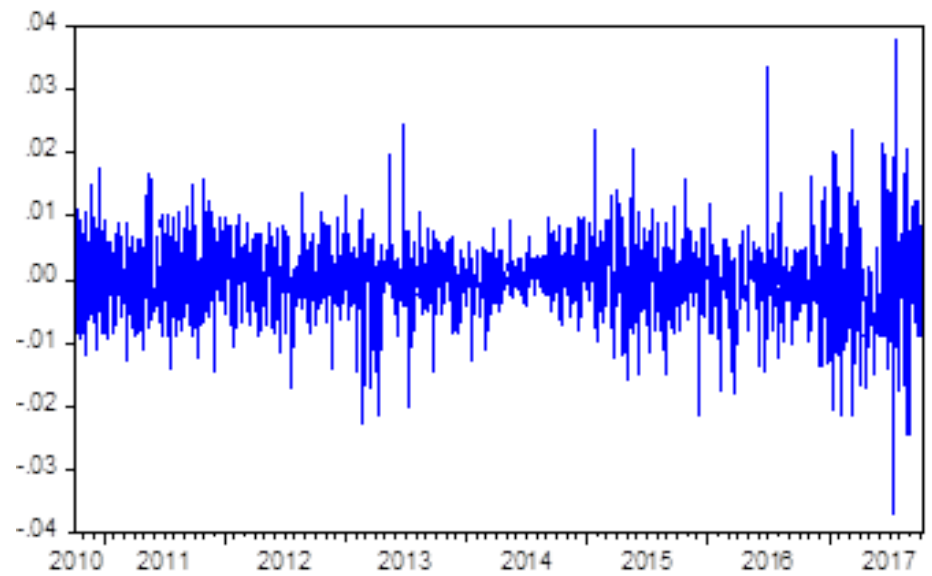
D_LOG_CLP



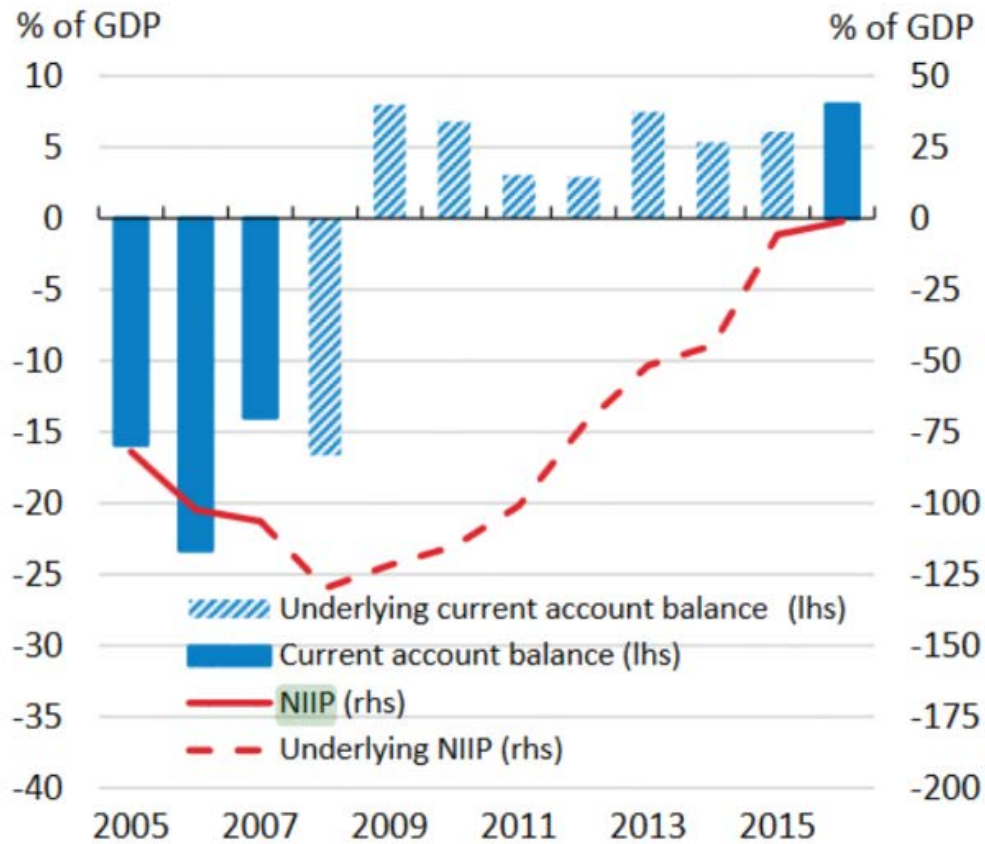
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D_LOG_ISK



Current account and the Net International Investment Position



Four main conclusions/recommendations

- It is important to realize that *there is no “silver bullet” in terms of monetary regime/policy.*
- At the current time the best monetary regime for Iceland is *“flexible inflation targeting.”*
- *However, some improvements to policy can be undertaken. (Details below).*
- *Need for support policies: Labor market flexibility, pension funds liberalization, fiscal support.*

ANNEX:
MODELS FOR ASSESSING EXCHANGE
RATE EQUILIBRIUM: A BRIEF REVIEW
AND SOME REFLECTIONS REGARDING
ICELAND