Foreign exchange market intervention in Iceland

Arnór Sighvatsson, Deputy Governor of the Central Bank of Iceland.

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I would like to thank the organisers for inviting me to participate in this panel. Foreign exchange market intervention is a topic highly pertinent to the conduct of monetary policy in small, open and financially integrated economies. Furthermore, running independent monetary policy with a floating exchange rate in an economy roughly as large as a medium-sized city brings some extra challenges. Let me mention a few of them:

1. A small economy tends to be less diversified than larger economies. Relatively few firms dominate the export, retail, and finance sectors, and these dominant players are in a position to have considerable impact on the economy, both directly and indirectly, via the foreign exchange market.
2. Only three banks serve as market makers in the interbank market for foreign exchange. As a result, it frequently happens that all of the market makers want simultaneously to have either more or less foreign currency on their balance sheets, potentially resulting in an exchange rate spiral that must be broken by the Central Bank to avoid excessive fluctuations in the exchange rate.
3. The pass-through of exchange rate movements into prices has historically been quite strong, which makes it challenging to anchor inflation expectations to the target when exchange rates are volatile. There have been improvements on that front, but it remains to be seen how permanent the recent changes in the anchoring of inflation expectations and the exchange rate pass-through will be.

Broadly speaking, these challenges and the need to build up reserves after the financial crisis of 2008 motivated foreign exchange market intervention in recent years. More precisely, it can be useful to distinguish among five types of motives that, to varying degrees, have guided intervention policies in Iceland:

1. Intervention can be a useful auxiliary tool for monetary policy**,** directly, by affecting a major source of changes in the price level, or indirectly, by helping to anchor inflation expectations to the target, thus contributing also to moderate wage settlements. Since inflation targeting was adopted in Iceland in 2001, there have been three identifiable episodes where intervention apparently had a clear monetary policy objective: in 2001 and again in 2008-2010, when inflation was above target and the króna was weak, and over the past three to four years, when inflation has been below target and the króna strong.
2. Replenishing reserves and achieving optimum reserve size following large-scale intervention to support the króna in the wake of the financial crisis, was a major objective of intervention in the past four years, until early in 2017. Foreign exchange reserves had fallen far below relevant benchmarks for reserve adequacy. Moreover, it was essential to build an extra reserve cushion to cover the risks associated with lifting capital controls. The reserve objective was one of two publicly stated objectives of intervention in the market. There appears to have been limited conflict between the reserve objective and the inflation objective, at least in the recent term, as inflation has been below target for almost four years. However, in retrospect, it could be questioned whether reserve accumulation started too early, at an exchange rate that was too low. Had the strong recovery of terms of trade and exports been anticipated, intervention policy could have been geared more towards achieving the inflation target rather than replenishing the reserves.
3. In addition to the monetary policy objective, which I have already mentioned, there may be microeconomic reasons for smoothing out excessive short-term volatility unrelated to macro fundamentals, as such volatility could discourage trade and impose direct welfare costs. Reducing volatility has been the second publicly stated objective of intervention. In recent years, intervention has actually kept volatility at an unusually low level, but perhaps that was more because there were three other reasons for intervening at that time, when the króna was under strong sustained upward pressure: i) accumulating reserves, ii) preventing inflation from falling too much below target, and iii) alleviating potential exchange rate misalignment that could pose a risk to the process of lifting capital controls.
4. The króna has fluctuated quite widely in real terms since the inflation target was adopted (and actually, before then as well), especially considering the size of the economy and the degree of exposure to foreign currency risk. Excessive deviation from the long-term equilibrium real effective exchange rate (EREER) can have a detrimental medium-term effect on financial and price stability. It therefore makes sense to lean against and, under extraordinary circumstances, try to halt exchange rate movements that are considered to entail misalignment. The financial stability motivations can assume weighty dimensions if unhedged FX

exposures are substantial and signs of exchange rate misalignment are fairly clear. Intervention that moderates large swings may also be welfare-enhancing in themselves, by reducing risks to businesses and households. As strong as the case for intervention may appear in retrospect, however, it is noticeable that estimates of the equilibrium real exchange rate have broadly tracked the market exchange rate, although the confidence interval of these estimates is fairly large. A limited ability to foresee movements in the equilibrium rate may reduce the ability and propensity of policymakers to curtail misalignment in real time. The willingness to act decisively may depend on strong faith in the mean reversal tendency of the real effective exchange rate (REER), which is difficult to establish if the observed mean to which the rate supposedly converges is changing. In the case of Iceland, preventing misalignment *per se* has probably only been a secondary motivation on perhaps two occasions: in the aftermath of the financial crisis in 2008-2010, and again this past spring. Although some Monetary Policy Committee members have certainly been concerned about potential misalignment, this has not been supported by contemporaneous measures of the EREER, and their concerns may have been overshadowed by the fact that in any case, the intervention was consistent with both inflation objectives and reserve objectives. In 2005, a case could have been made for intervention to prevent misalignment, but no intervention occurred at that time, perhaps because intervention seemed at odds with the inflation target, given that inflation expectations were poorly anchored. Better anchored inflation expectations would facilitate a longer policy horizon for decisions on intervention to deal with FX misalignments.

5. Finally, it cannot be ignored that central banks can suffer losses on their interventions. Efforts to smooth out a sharp reversal that occurs at a high level of REER after long periods of appreciation could, for example, result in central bank losses if the reversal turns out to be driven by stronger-than-expected underlying forces. To avoid defending an unsustainable exchange rate level, a flexible intervention strategy is of the essence. A more difficult problem emerges when losses accrue over an extended period of intervention-generated reserve accumulation when interest rate differentials are wide. Although the balance sheet of the central bank should be of secondary concern given its legal mandate, and temporary losses need not be a cause of concern, protracted periods of substantial losses, especially if they result in negative CB equity, could weaken the CB's independence. Hence it is wise to avoid large central bank losses to the extent consistent with the legal mandate. There are, indeed, a number of ways a central bank could limit or recover losses on its balance sheet without deviating from its mandate.

    a. The central bank could oblige commercial banks to share some of the cost of providing the public good of strong reserves, from which the banks benefit immensely. Recently, the CBI has applied unremunerated reserve requirements (URR) mainly to reduce the incentive for non-residents to invest in short-term, safe liquid assets in domestic currency. The aim has been to underpin long-term financial stability and to reduce distortions in the monetary policy transmission mechanism caused by strong capital inflows, which tend to divert transmission from the interest rate channel to the more erratic exchange rate channel, causing undershooting of the inflation target in the short-term and, potentially, overshooting at a later stage. This has had the side benefit of alleviating the need for intervention and reducing losses on the reserves.

b. As reserves become larger and the need for liquid reserves has been met, the case for reducing losses by investing larger share of them in a diversified portfolio of higher-yielding but less liquid assets becomes stronger.
c. According to current legislation and based on an authorisation contained in the National Budget, the Central Bank of Iceland has the option to call on Treasury pledges to contribute capital to the Central Bank in the form of marketable assets, provided that the Bank considers this necessary in order to fulfil its minimum requirements for paid-in capital. Callable equity makes it possible to share part of the cost of the reserves with the Treasury, which also benefits substantially from the public good of having ample reserves, by lowering interest payments on its foreign debt. However, in order not to provoke an assault on central bank independence, it is probably wise to consider that option as a last line of defence.

To sum it all up: The motivations for CBI intervention have varied over time, depending on circumstances. Not all of the above motivations have always been internally consistent, but most of the time conflicting motives have been of secondary concern.