Central Bank of Iceland

Small, open, and financially integrated economies (SOFIEs) and the international monetary and financial systems (IMFS)

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Outline

- Two perspectives on the global economy and the international monetary and financial system(s)
- Global financial integration and the interaction of monetary policy and financial stability in SOFIEs
- The individual country response
- Reforms to the IMFS

Two perspectives

- Common (pre-crisis) perspective:
  - Global current account imbalances
  - Asymmetric adjustment
  - Keep your house in order
  - Official arrangements: lending to sovereigns of debtor countries to facilitate balance of payments adjustment
- Alternative perspective:
  - Global financial integration
  - Financial imbalances
  - Spillovers and feedback
  - Keeping your house in order is necessary but not sufficient
  - Additional instruments: e.g., liquidity provision to internationally active banks – CB swaps

Two perspectives

- Not mutually exclusive
- Official arrangements such as IMF facilities are lagging in the second perspective

Global financial integration and SOFIEs: theory

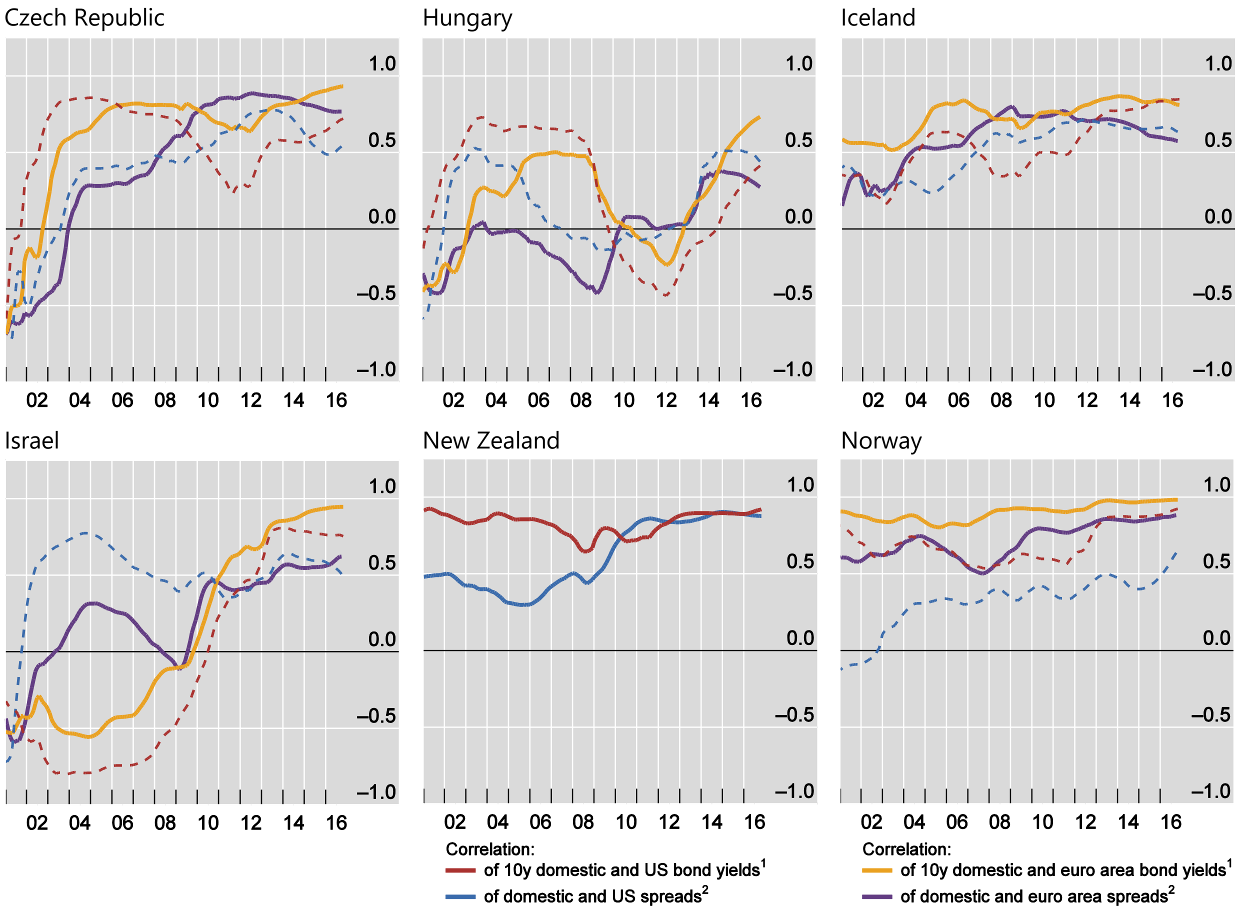
- Taking global financial integration to its economic extreme and assuming constant risk premia =>
- Long-term rates in SOFIEs become determined by monetary policy in the big countries (core rate-setters)
- Inflation targets can still be reached through the exchange rate channel
- If exchange rates are "well behaved" and the financial sector sufficiently regulated and supervised =>
- A floating exchange rate and "keeping your own house in order" is sufficient for independent monetary policy and financial stability

Global financial integration and SOFIEs: empirics

- Data on long-term rates and spreads consistent with the story (and a lot of other empirical work as well) – we are still some way from the theoretical limiting case
- Before the crisis, some argued that these patterns could be due to common shocks, the spread of similar monetary policy frameworks (IT around 2% and CB policy rates as the main instrument), and increased credibility
- Case studies, comparisons of pre- and post-crisis periods, and other observations make it more and more plausible that GFI is the main driver
- It is also at play between big countries

Evolving correlations between SOE and US/euro area sovereign yields

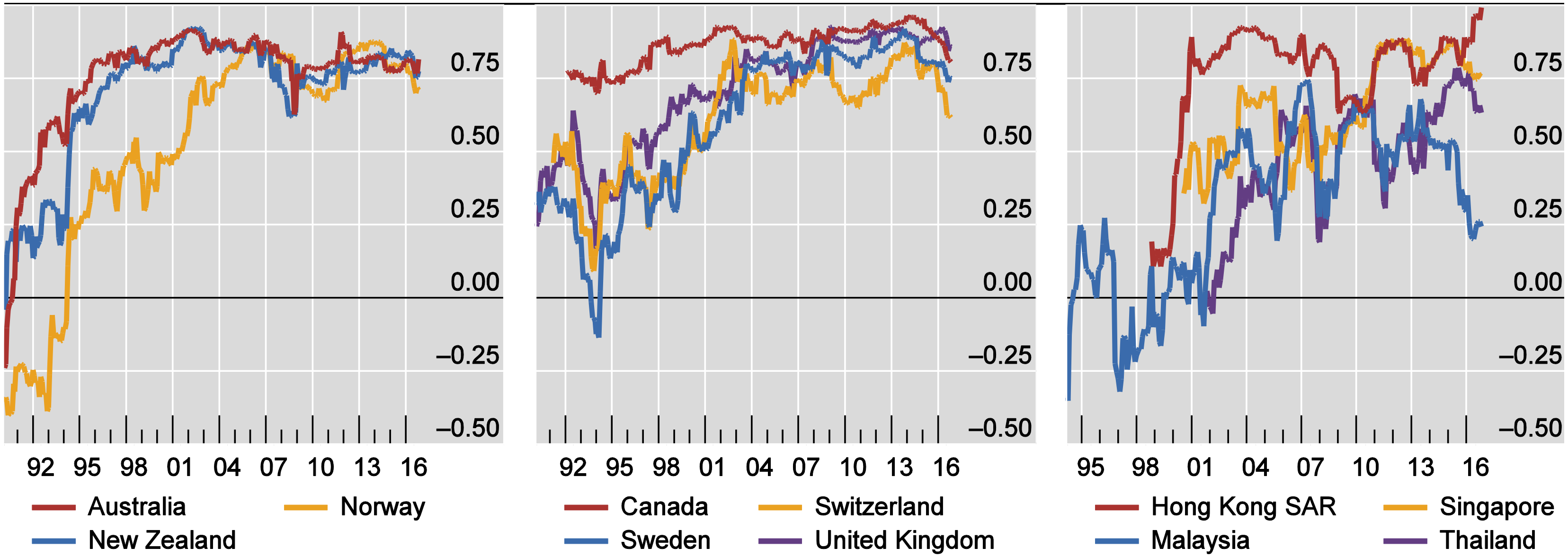
10-year rolling correlations, average monthly yields



[1] Rolling correlations between the domestic SOE and US 10-year government bond yields. For European countries, also with euro area 10-year government bond yields. [2] Rolling correlation between the domestic SOE and the US and euro area short- and long-term sovereign spreads. The short-term interest rate is a 3-month market rate and the long-term yield is a 10-year government bond yield.

Sources: Bloomberg, Datastream, BIS, BIS calculations.

Correlation between domestic and US long–term yields[1] Graph Number



[1] Monthly changes using a 36–month moving window; for Hong Kong SAR, Malaysia, Singapore and Thailand, 24–month moving window. Ten-year bond yields.

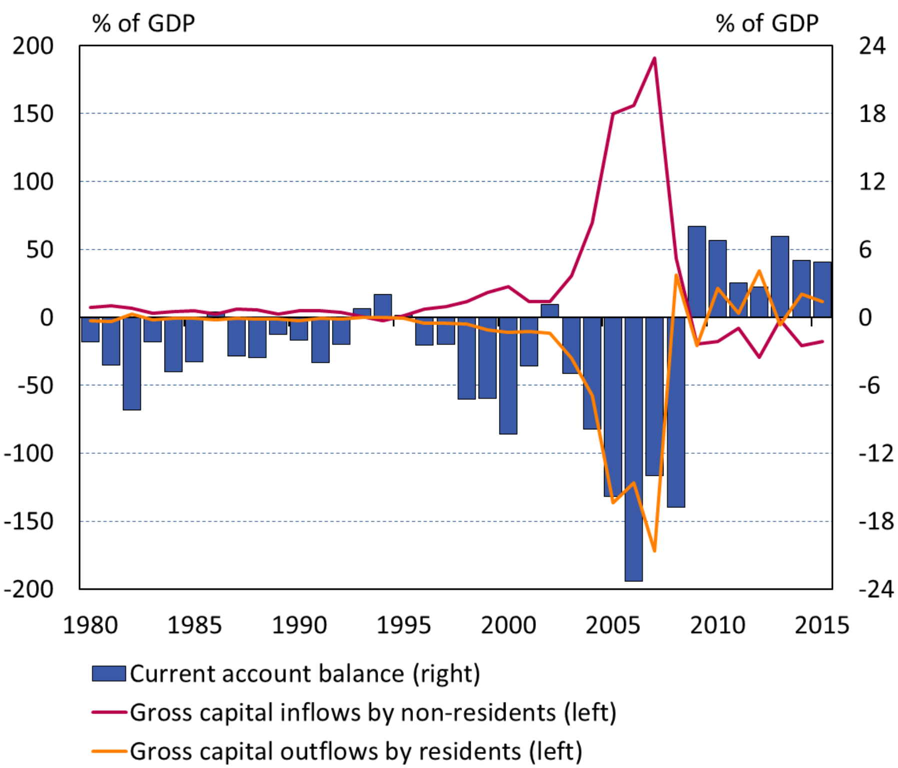
Sources= Bloomberg; national data.

GFI and SOFIEs: problems

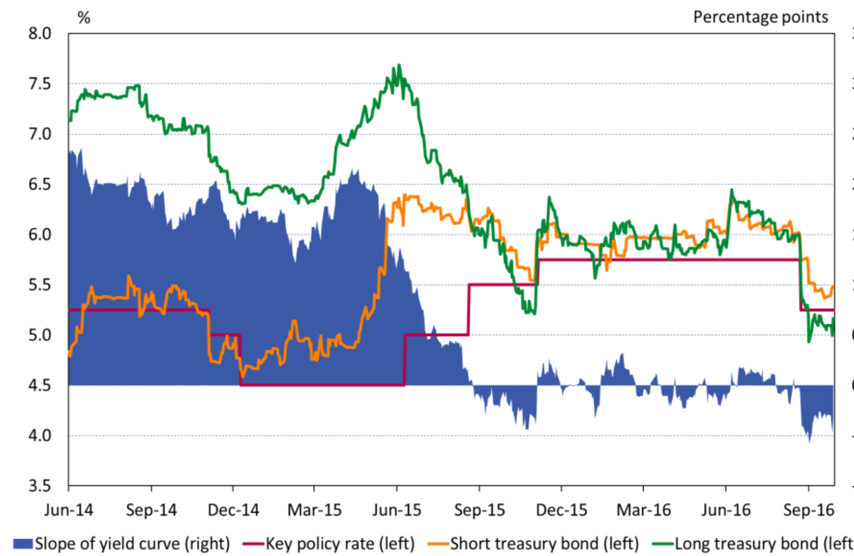
- Exchange rates do not smoothly reflect fundamentals: UIP does not hold except in the long run and then with sharp and disorderly corrections – carry trade
- Volatile capital flows driven by push factors (global financial conditions)
- Interaction with financial vulnerabilities; e.g., domestic currency mismatches and international activities subject to regulatory gaps of domestically headquartered banks
- Behind empirical conclusions that IMP is becoming more difficult in SOFIES, irrespective of the exchange rate regime (e.g., Rey)
- Still a trilemma but with trade-offs of variable severity

The case of Iceland

Gross capital flows and current account balance 1980-2015[1]



Central Bank policy rate and bond yields
1 June 2014 - 30 September 2016



Gross capital flows played a key role in the financial crisis in Iceland.
On a lesser scale, potential risks from gross capital inflows have returned as an issue in the recent period.

Global financial integration and SOFIEs: conclusions

- A floating exchange rate is not sufficient for “safe” monetary policy independence
- It is becoming increasingly difficult for SOFIEs to conduct independent monetary policies without creating risks to financial stability
- Keeping your own house in order is not sufficient

What can countries do on their own?

1. Give up on independent monetary policy
2. Increase resilience
3. More tools
4. Improve analytical frameworks: more focus on level and composition of gross flows and stocks
5. National balance sheet risk management

We should do 4 and 5 in all cases

1 does not preclude 2 and 3 for other reasons than to facilitate IMP

Give up on independent monetary policy

- Monetary union
- Fixed exchange rate
- Interest rate pegged to those of global rate-setters
- Other policies have to take care of domestic economic stabilisation – but will they?

Increase resilience

- The aim is to increase the ability to live with exchange rate fluctuations (reduce the fear of floating)
- Regulate FX risk on bank balance sheets, currency mismatches, etc.

More tools

- Some such tools will actually decrease the level of financial integration (but hopefully where it matters less for efficiency and growth):
  - FX intervention
  - “Orthodox” macropru
  - Capital flow management
- I have sometimes named this *inflation targeting plus*

Prudential regulations or tools after capital controls in Iceland

	Regulation or tool	Status
a)	LCR and NSFR in FX	Implemented
b)	Restrictions on deposit taking in foreign branches	Partly restricted by a) – future issue
c)	Limits on FX imbalances	In progress
d)	Restrictions on FX lending to unhedged borrowers	Before Parliament
e)	Capital flow management tool for capital inflows	Implemented

What does this mean for reform of the IMFS?

- Review IMF surveillance and facilities and other parts of the global financial safety net in light of the second perspective (begun, e.g., new reports, new facilities (PCL and FCL), and stock-taking of IMS and GFS)
- Reduce financial regulatory flaws and gaps at the global and regional level – capital flows and cross-border banking
- Institutionalisation of CB swaps?
- Accommodate but monitor SOFIEs' unilateral use of additional tools (CFM tools in particular)
- Rules of the game?

Move on three fronts:

- Enhance the analytical framework:
  - A broader perspective on the international monetary and financial systems
  - Broader analysis of risks in flows and stocks: both net and gross
- Individual country responses
- Reforming relevant aspects of the IMFS