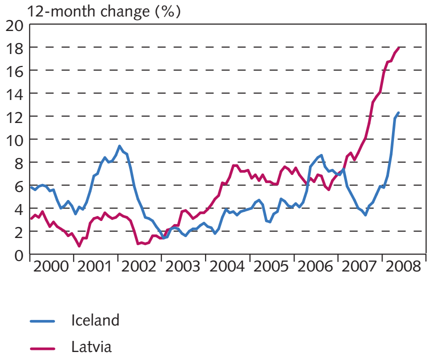
Appendix 3

Iceland and Latvia: Macroeconomic adjustment and monetary policy

It is instructive to compare the success of economic policy in Iceland to that of other countries that face similar problems but adhere to different monetary policy arrangements, such as a fixed exchange rate policy. In recent years, Iceland and Latvia have been battling high inflation, fuelled largely by burgeoning domestic demand, and a wide current account deficit. Strong growth in lending has generated demand-driven inflation in both countries, as well as contributing to rising real estate prices. The difference between the two is that Iceland adheres to autonomous monetary policy and a floating exchange rate, while Latvia follows a fixed exchange rate policy, with its currency, the lats, pegged to the euro.

From 1991, when Latvia gained independence, until 1998, inflation was very high, initially because of necessary changes accompanying the departure from a centrally planned economy. A period of price stability followed, with annual inflation remaining close to 2% until 2004. Since 1994, Latvia has adhered to a fixed exchange rate policy. On January 1, 2005, the lats was pegged to the euro instead of the previous currency basket consisting of the US dollar, the euro, the pound sterling and the yen. This was done to guarantee stability and increase foreign investment and exports, as well as facilitating the adoption of the euro. At around that time, however, a period of mounting inflation began, similar to that in Iceland. Since 2004, inflation has only once fallen below 6%. In April 2008, annual inflation measured 17.5%, its highest level since August 1996. Most of the symptoms were the same as in Iceland. The current account deficit rose from 4.8% of GDP in 2000 to 22.8% of GDP in 2007. Lending has grown very rapidly in recent years, although foreign-denominated loans, particularly loans in euros, are more common than in Iceland. In 2007, 86% of loans granted in Latvia were denominated in euros.

Chart 1
Inflation in Iceland and Latvia
January 2000 - May 2008



Sources: Statistics Iceland, Statistic Latvia.

The impossible trinity

According to the impossible trinity theory, a nation can choose only two of the following three options: free capital movement, autonomous monetary policy, or a fixed exchange rate.[1] The reason is that if a country decides to allow free capital movement and maintain a fixed exchange rate, monetary policy will be bound by the fixed exchange rate and will therefore be in the hands of the central bank of the country to which the currency is pegged. An interest rate hike implemented to combat inflation, for example, will cause capital to flow into the country, and the currency will appreciate, which is incompatible with the fixed exchange rate policy. Iceland and Latvia have both chosen to allow free movement of capital, but the Icelandic government has

1. Mundell, Robert A. (1963), "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates." *Canadian Journal of Economics and Political Science*, 29(4), pp. 475-485.

Chart 2
Current account in Iceland and Latvia
% of GDP 2000-2007

Sources: Central Bank of Latvia, Statistics Iceland, Central Bank of Iceland.

elected to maintain autonomous monetary policy, while the Latvian government adheres to a fixed exchange rate. This is natural in view of Latvia's plans to adopt the euro, preferably no later than 2012, as the country has been an EU Member State since 2004. It is worth mentioning that, in order to meet the requirements for membership in the European Monetary Union (EMU), a country must join the ERM II, which implies that the exchange rate of its currency may not deviate more than ±15% from a central rate against the euro for two years prior to EMU entrance.[2] Some countries have adopted a narrower exchange rate band. Iceland and Latvia use different tools to combat inflation; however, the fundamental role of monetary policy is the same in both countries: to provide a credible anchor for inflation expectations. In Latvia this is done by guaranteeing a fixed exchange rate of the lats against the euro. This engenders an economic adjustment because of the deteriorating competitive position resulting from a rising real exchange rate, which curtails GDP growth in the long run. Iceland seeks to anchor inflation expectations through a formal inflation target and systematic, transparent monetary policy conduct.

Government measures in Latvia

Although the Latvian government does not maintain autonomous monetary policy and therefore cannot use monetary policy to affect economic developments to any marked degree, it can influence demand through general economic policy. In April 2007, the government launched a campaign against inflation, with the aim of cooling down the overheated economy. The campaign involved a government pledge to balance the fiscal budget, bringing the budget into balance in 2008 and into surplus in 2009 and 2010. Furthermore, the government promised not to reduce taxes in the near future and to amend the tax code so as to make the tax environment less favourable to speculators. An important element in this campaign involves regulatory changes to the credit market. The government set more stringent rules for banks' lending to individuals, thereby attempting to contain lending growth. Furthermore, it is working toward improvements in the labour and energy markets and is making an effort to increase competition and eliminate monopolies. The government has also pledged to impose ceilings on public sector wage rises.

One of the Bank of Latvia's few available instruments to contain credit growth has been reserve requirements. During the credit boom of 2005-2007, however, reserve requirements have been of limited effectiveness in raising banks' lending rates or slowing credit rates, since the rules have partly been circumvented through, for example, longer-term foreign exchange funding. The bank raised the ratio from 6% to 8% at year-end 2005 but began to reduce it again at the beginning of 2008, in response to the global credit crisis. The reserve requirement now stands at 6%. The Bank of Latvia concluded that the credit market had slowed down enough to justify this reduction, but the bank's reserve requirement must equal that of the European Central Bank, 2%, before the country adopts the euro. The Latvian economy has

2. For further discussion, see Appendix 4 in this issue of *Monetary Bulletin*.

slowed down in recent months, with GDP growth in Q1/2008 negative by 1.9%.

The dilemma of choosing exchange rate arrangements for small, fast-growing open economies with unrestricted capital flows

The Latvian economy has grown by leaps and bounds in the past few years. Measured at constant price levels, GDP rose by over 10% in 2007 and more than 12% in 2006. It could be argued that a fixed exchange rate policy is poorly suited to a country undergoing such rapid growth. When the exchange rate is pegged to the currency of a developed country with slower GDP growth, such a policy means that nominal interest rates will be low compared with GDP growth. Increases in the relative price level or the real exchange rate, which are inevitable when countries become more wealthy (the so-called Balassa-Samuelsson effect), materialise as rising prices rather than as a rising exchange rate. The Bank of Latvia's policy rate has been 6% since May 2007, after having remained in the 3-5% range since 1997. This means that the real policy rate in Latvia has been negative since 2004, when inflation took off again. A negative real policy rate has prompted a surge in lending. This in turn has boosted domestic demand and sparked higher inflation and a wider current account deficit. A rise in the real exchange rate will ultimately curtail growth and bring inflation down, given that the exchange rate remains fixed. This is doubtful, however, in view of the current account deficit, but it should be pointed out that, through its bilateral agreement with the European Central Bank, Latvia has a stronger backstop for the fixed exchange rate than Iceland had during its fixed exchange rate era. Furthermore, Latvia's foreign exchange reserves are relatively large, at least as large as the supply of money in circulation. In countries with a currency board – such as Latvia's neighbours, Estonia and Lithuania – the central bank is commonly required to maintain substantial foreign reserves. Sizeable foreign reserves enhance the ability of the Bank of Latvia to keep the exchange rate of the lats stable and to build confidence in the currency, as it is easier to avoid attacks by speculators.

The other option for conducting monetary policy is a floating exchange rate and an inflation target. However, small open economies that choose this arrangement face the problem that the pass-though from exchange rate fluctuations to the domestic price level is stronger than in larger economies.

Iceland's battle with inflation

For decades, monetary policy in Iceland was based on various fixed exchange rate policies, which were enforced using methods that varied in their credibility. The fixed exchange rate policy had run aground by 2001, when the króna was allowed to float and inflation targeting adopted. In recent years, the Central Bank of Iceland has exerted stringent monetary policy in an attempt to control inflation. This has not been successful, however, as has been discussed in detail in *Monetary Bulletin*. The problem is the same as that in Latvia, although the methods of addressing it differ. It is likely that a difficult economic adjustment is ahead for both countries, and it will be interesting to compare how they fare, even though they differ in many respects.