

Már Gudmundsson¹

The strengthening of the exchange rate and economic policy challenges

*Speech given at a meeting organised by the Icelandic Federation of Industry,
June 24, 2003*

Ladies and Gentlemen:

I would like to begin by thanking the Federation of Icelandic Industries for organising this meeting. It is crucial to discuss the challenges posed to economic policy by the large-scale investments in aluminium and hydropower production. A precondition for being able to steer the economy safely through the perilous waters that lie ahead is to analyse the problem correctly. If the map and the course are wrong there is a risk that we will run aground. On board a ship it may be enough for the captain and officers to know the course, but to avoid a mutiny it is better for the whole crew to be aware of it as well. This is true in modern society at least, and is what makes this discussion so important. The discussion is not beginning at this meeting, nor will it end here. It started at the beginning of this year when it became clear that the marked strengthening of the króna in the closing weeks of 2002 could become permanent. Initially the debate was quite misguided, with some claims that the Central Bank was to blame for the appreciation of the króna and could easily readjust the exchange rate without even any long-term consequences for the inflation target set in its joint declaration with the

Government of Iceland from March 2001. Today, I believe, most people realise that the issue is a much more complex one. This discussion, and also the statements by the OECD and IMF, have helped to create a deeper understanding of the issue.

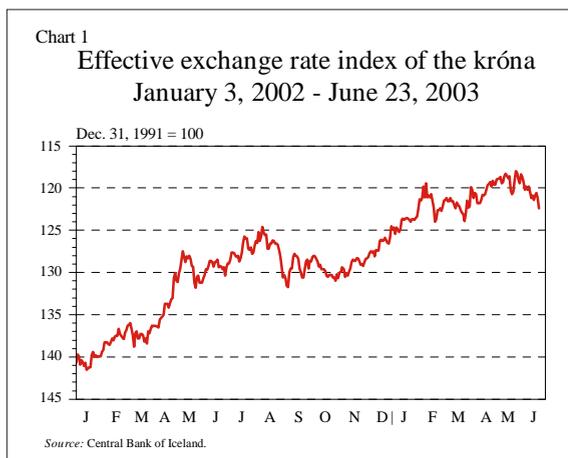
I intend to discuss in particular here today the monetary policy aspect of this issue. However, this cannot be done without some discussion of the total context and the role of other spheres of economic policy. I shall begin by examining exchange rate developments in recent months and the current position with respect to the real exchange rate. Afterwards I shall attempt to explain the cause of this development on the basis of events that occurred over the period. This will focus on the planned aluminium-related investments and I shall then address their economic impact, especially on the real exchange rate of the króna. Then I shall ask how serious this development has already become for businesses and possible problems that may lie ahead on that front. Afterwards I shall turn to monetary policy and its potential for influencing the exchange rate. Finally, I shall discuss the optimal response to the challenges that we face.

1. Chief Economist of the Central Bank of Iceland. The author would like to thank Arnór Sighvatsson, Ásgeir Danielsson, Gudmundur Gudmundsson, Gylfi Zoega, Ingimundur Fridriksson, Jón Steinsson and Ólafur Örn Klemensson for their constructive remarks and Elin Guðjónsdóttir and Gudmundur Sigfinnsson for their assistance with the data and graphics. The author is, however, solely responsible for the content of the speech.

Exchange rate developments

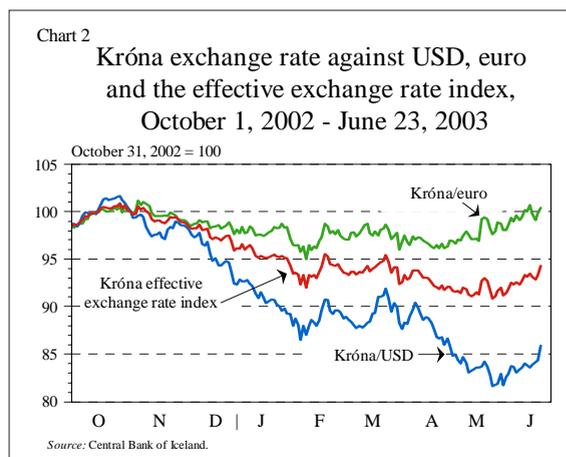
For most of last year the króna strengthened after a sharp dive in 2000 and 2001. This development was welcomed all round, because the króna had weakened far in excess of what was needed to restore medium-term internal and external economic bal-

ance, as typically happens when a currency slide is caused by imbalances and lack of confidence. Had the króna remained at the weak level of late in 2001 it would eventually have threatened both the inflation target and financial stability. Towards spring 2002 the króna had approached what was widely considered to be its equilibrium rate, at around 130 points on the exchange rate index. However, it should be underlined that a statistical evaluation of the equilibrium exchange rate at any given time is fraught with uncertainties and it could just as easily have been at least 5% higher or lower. In fact, many people would claim the range of uncertainty is much wider. In any event, the exchange rate remained within that spectrum for the rest of the year.

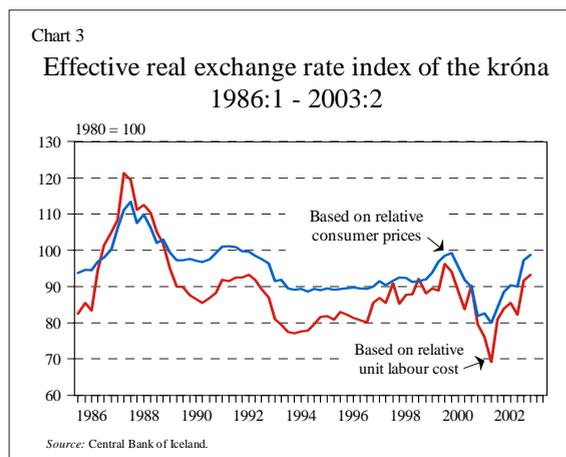


Towards the end of October the exchange rate was broadly the same as in the spring, having fluctuated within a fairly narrow range apart from some strengthening in mid-summer. But after the end of October a steady appreciation followed and the exchange rate is currently more than 6% stronger than then, and for a while last month in fact it had gained 10% compared with that time. It should be pointed out that this trend has gone hand in hand with a slide in the US dollar against the euro amounting to more than 15%. Naturally this is totally independent of economic developments in Iceland and beyond the influence of domestic economic policy. However, one consequence is that the króna has strengthened by more 16% against the US dollar. Of course this has had sizeable consequences for the profitability of exporters who earn dollars and have not hedged

against currency risks. Interestingly, the króna has remained relatively stable against the euro during this period, as shown in Chart 2; in fact yesterday it was marginally lower than at the end of October.



Where has this development left the real exchange rate, which is more important than the nominal exchange rate when we consider the profitability of export and import-competing industries? As Chart 3 shows, the real exchange rate has bounced back from the dive that accompanied the exchange rate index overshoot in 2001. In the current quarter, the real exchange rate can be estimated somewhat higher than both its ten-year and twenty-year historical average. It is now similar to the peak of the last upswing but, fortunately, well below the level at the end of the 1980s.



What is the explanation for the exchange rate appreciation?

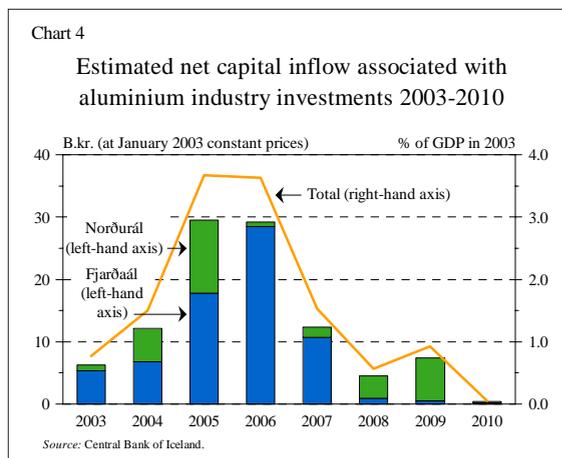
The explanation for the exchange rate appreciation must lie in changes or new information which has emerged over this period. On closer scrutiny it seems that the appreciation can be attributed to three closely related factors. Firstly, greater confidence in economic growth and stability. Secondly, expectations in connection with the aluminium industry investments. Thirdly, exposures taken by foreign investors in Iceland's foreign exchange market.

Towards the end of last year the inflation target had been attained and the current account deficit had vanished. A major investment in the Fjarðaál aluminium project (Alcoa) also looked increasingly likely and has since been confirmed early this year. GDP growth prospects therefore improved significantly and there was little probability of a depreciation of the króna for the time being. Investors had been taking a growing interest in the domestic bond market on account of high interest rates, but because they generally hedged their purchases these had no effect on the exchange rate. However, there are indications that after the go-ahead was given for the aluminium industry investments, foreign investors have been increasingly taking unhedged positions in bonds or have even engaged directly in short-term speculation in support of the króna. Exactly how large a part this has played in developments, on the other hand, is difficult to say at this stage.

So how and why does investment in the aluminium industry over the next few years have an effect on the exchange rate now? The reason is that foreign exchange market participants know that this project will be accompanied by a substantial net currency inflow, i.e. over and above what is needed to finance imports and the wages paid to foreign labour in connection with it. This will contribute to strengthening the exchange rate at that time, but affects it immediately since in an environment of unrestricted capital movements, pricing in the FX market is largely based on future expectations. The other reason is that it is known that the Central Bank's policy rate will go up when the construction phase approaches, which is immediately reflected in long-term interest rates due to the close correlation between them at any time and expected short-term rates. The interest rate differential with abroad therefore increases at the long end of

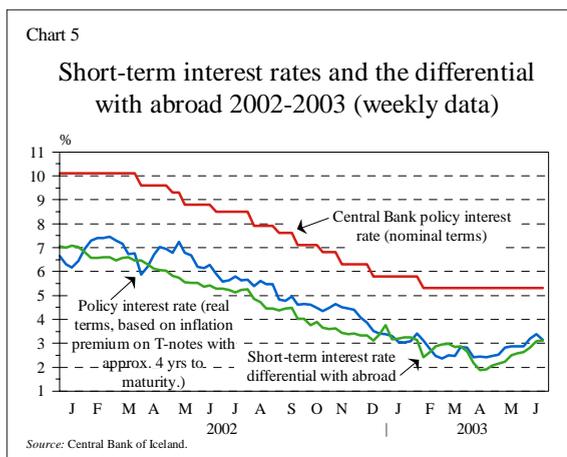
the market, drawing in more capital and putting upward pressure on the exchange rate.

Thus it is a misconception to claim that aluminium industry investment cannot have any substantial impact on the exchange rate at present because of how far away its peak is in 2005 and 2006. The point is that it is known that this peak will occur, and exactly when. Furthermore, the construction projects will generate a sizeable capital inflow both this year and next year, especially if the Norðurál smelter expansion is realised as well, as market participants appear to assume since it is incorporated into official forecasts. Estimated net capital inflow in connection with the Fjarðaál and Norðurál projects and hydropower facilities related to them will amount to more than 18 b.kr. this year and next year compared with almost 30 b.kr. per year in 2005 and 2006. This phase of the Norðurál expansion has not been finalised, however, so the exchange rate could depreciate if it does not materialise.



But isn't the tight monetary stance the main explanation for the strengthening of the exchange rate, as has been claimed? On closer examination this explanation does not hold. Over the period examined here, the only changes in the monetary policy stance have been to ease it, as Chart 5 shows. Considerable cuts have been made in the Central Bank policy rate in recent months, and the interest rate differential with abroad has followed suit. Admittedly, the interest rate differential has widened again in recent weeks after cuts in foreign rates, but as it happens the króna has been weakening too, although in fact for

completely different reasons. The banks' minimum reserve requirement in the Central Bank has been lowered and the Central Bank has bought substantial amounts of currency with the aim of boosting its net foreign reserves. Theory and empirical evidence alike teach us that such currency purchases have only a short-lived impact on the exchange rate if any at all, but in any case it cannot be claimed that the Bank's measures aimed to bolster the króna.



In this context it is worth remembering the effect that the interest rate differential has on the exchange rate when capital movements are unrestricted. Under such conditions, yields in domestic and foreign bond markets tend to be equalised after allowance for expected exchange rate changes and risk premiums. In other words, domestic interest rates will be equal to foreign rates plus the expected depreciation of the domestic currency (and risk premium). All things being equal, a rise in domestic interest rates causes an appreciation of the exchange rate now and expectations of a corresponding depreciation in the future. This means that the interest rate differential with abroad should be widening if it is the sole explanation of the stronger exchange rate, but on the contrary it has been moving in the opposite direction for most of the period. Admittedly, this picture is complicated by the probable decrease in risk premiums with the restoration of stability, which would make the interest rate differential more effective; other things being equal, this would contribute to a stronger exchange rate. Furthermore, the differential at the longer end of the market has not closed up to the same degree as at

the short end, partly because of expectations connected with aluminium industry investments. Inflation-indexed long-term interest rates are also very high in Iceland compared with trading partner countries where such instruments are issued.

Of course it can rightly be claimed that monetary policy has played an indirect part in this process by contributing to stability and greater confidence, which in turn drives up the nominal exchange rate. Had this not been achieved, the nominal exchange rate would probably be weaker now. But inflation would be higher too, so it is by no means certain that the real exchange rate would have been weaker, which in the final analysis is the crucial factor for export and import-competing industries.

Aluminium industry investment and the real exchange rate

It is important to bear in mind that new investment in the aluminium industry will raise the real exchange rate. Construction work for this project will cause greater demand than otherwise for several years, which will push up prices and wages compared with trading partner countries. Monetary policy cannot alter this except in the short run, but it can affect the distribution of the higher real exchange rate between the nominal rate and a higher rate of inflation than among trading partner countries. The impact of monetary policy on aggregates such as GDP growth, real exchange rate, the current account balance, etc. rarely lasts for more than 1-2 years, after which it only affects inflation. This is true if the monetary stance is within reasonable limits. A lax stance which leads to a very high rate of inflation over a longer period can of course hurt GDP growth, and so can an excessively tight stance if it results in severe deflation. This is also true if defending a fixed exchange rate causes excessively high real interest rates over a longer period, cf. Argentina.

A real exchange rate appreciation is one of the economy's mechanisms for accommodating the aluminium-related investment activities. It does not imply that the exchange rate is on an abnormal path away from the equilibrium rate, at least not from medium-term equilibrium; rather, it is the equilibrium exchange rate that rises while construction is in progress. So is there any problem? Isn't this just the normal functioning of market forces, which will ulti-

mately produce a desirable result? Of course such a case can be argued, but in my view this nonetheless does pose a problem. In my opinion Iceland is now experiencing its first substantial symptoms of the “Dutch disease”, whereby capital inflows and the use of limited labour and capital to develop a new export industry squeezes existing industries. The problem has at least two sides. Firstly, the temporary strengthening of the real exchange rate nonetheless could last long enough to cause significant harm to existing export and import-competing sectors. The risk is that when the real exchange rate settles back down, their foundation will have weakened so much that they will take a considerable time to recover. Secondly, there is always a risk that a volatile exchange rate will overshoot both when rising and falling, partly if expectations are unstable. When the construction activities are completed this could cause a significant fall in the exchange rate which would create difficulties for economic policy-making.

So the question is: are there any ways to keep the real exchange rate in check during the construction phase, without sacrificing the inflation target and economic stability? My answer is: Yes, there are ways. Recently the Central Bank, as well as the IMF and other bodies, have been pointing out such approaches. They do not involve driving the exchange rate down temporarily with monetary measures, since this conflicts with the inflation target and will not result in a lower real exchange rate in the long run. Nor do they primarily entail tightening the monetary stance, since this will cause a short-term strengthening of the exchange rate which will mainly hit export and import-competing industries. No, these approaches involve measures to counteract the temporary appreciation of the equilibrium real exchange rate which is a consequence of construction activity. The obvious response is a tight fiscal stance and cutbacks in public sector construction projects for the duration of the aluminium industry construction phase, and also greater supply of imported labour and other factors of production.

We can tell from recent discussions that there is increasing understanding of this point. Ways of facilitating the import of labour during the construction phase are being discussed. And we heard in the last speech that the Ministry of Finance is currently planning fiscal countermeasures for the next few years.

However, the scope of this project is clearly so great that some appreciation of the real exchange rate cannot be prevented entirely, nor a higher Central Bank policy rate. Thus it is important for exporters to prepare themselves to face a period with the current level of the real exchange rate and possibly an even stronger one. This prompts the question I shall turn to next, namely how serious these industries’ position has already been made by the strengthening of the króna.

Position of export and import-competing industries

Since discussion has largely focused on the position of fisheries, I shall mainly concentrate on that sector. EBIDTA of listed fisheries companies during the first quarter of this year was much lower than in the same period in 2002, or 24% now compared with 34% then. In part this trend can naturally be traced to the stronger króna, but other factors are at work too, such as localised troubles in the shrimp and haddock industries, smaller capelin catches compared with last year and lower foreign prices of marine products. Fish processing has been hit by a revenue distribution problem within the overall fisheries sector whereby the prices it pays for raw material have not developed in line with export prices for products. The real exchange rate will probably strengthen in the range 1-2% between the first and second quarters of this year which will cause the profitability of fisheries and other export industries to diminish further. Offsetting this, quotas for cod and other species will be raised again in the new fishing year (from September 1) so that it is not certain that performance for the year as a whole will be poorer than during the first quarter, as is often the case. It should also be remembered that in terms of profitability, 2001 and 2002 ranked with the best years ever in fisheries history. Profitability of listed fisheries companies this year could easily surpass that in 2000, for example. Another point to bear in mind was that the equity ratio of listed fisheries companies was more than 34% at the end of the first quarter, probably one of the best figures for many years. Fortunately, the fisheries industry is better equipped now to absorb shocks. So it is a great exaggeration to claim that the industry is in ruins.

Monetary policy and the exchange rate

The Central Bank's inflation target can accommodate a weakening of the exchange rate from its present level in the near future. Inflation is currently some way below the target, although the core indices are close to it. According to the Bank's last forecast, inflation will remain below the target until the fourth quarter of next year. Then it will head upwards, not driven by the exchange rate but because pressures from aluminium industry construction projects are expected to make themselves felt by then. As it happens, the exchange rate yesterday was almost 2% lower than assumed in the Bank's latest forecast, but does not essentially change this scenario.

So is there nothing that the Central Bank can do to bring the exchange rate down? There is a lot less than many people think. Experience shows that interventions in the foreign exchange markets which are not made in tandem with changes in the policy rate generally have only a limited and short-lived effect. Our experience in this field in recent years has been analysed in detail in an article by Gerdur Ísberg and Thórarinn G. Pétursson in the first issue of *Monetary Bulletin* this year. The same applies – and for the same reasons – to measures such as domestic borrowing by the Treasury in order to prepay its foreign debt. It should be borne in mind that in recent months the Central Bank has bought a huge amount of currency in the foreign exchange market. Since last autumn, the Bank has purchased currency for 18 b.kr. until May 16 this year. That day it announced that it would step up its purchases from 1½ million to 2½ million US dollars per trading day. This means that the Central Bank's currency purchases this year will amount to 42 b.kr. assuming an unchanged exchange rate from June 19. This sum is equivalent to the entire estimated net capital inflow in connection with the Fjarðaál project, the Norðurál smelter expansion and related hydropower facilities this year and next year, plus the bulk of the inflow for 2005 as well. In spite of this, the króna weakened for only two days after this change was announced, by 1.7% in all, then settled back to its old level. Of course these purchases may have played some part in the depreciation of the króna in the past few days, but as with other foreign exchange market interventions which are not accompanied by changes in the policy rate, they will have no long-term impact.

It is difficult to justify a cut in interest rates in light of the most recent inflation forecast and GDP growth statistics for the first quarter. But we may ask what effect a policy rate cut would have on the exchange rate. In the present climate it can be argued that the impact would be negligible for as long as there is general confidence that the Central Bank will do what is necessary in order to attain its inflation target. The reason is that it is not the current Central Bank policy rate which is responsible for the strong exchange rate, but rather expectations that it will be high in the future. As long as these expectations remain unchanged, cutting interest rates now will do little more than fuel expectations about how much they will go up later. What needs to be changed are these expectations. In this respect there are three possibilities.

The first is that the market is overestimating the impact of the aluminium industry investments and/or other aspects of the economic position. In that case the task is to try to correct it. Sometimes the markets have patently overshot, for example when US equity prices were so high that they implied either extremely unrealistic long-term GDP growth or long-term profit equivalent to 100% of national income. However, in general it is far from certain that assessments by "experts" are any better than those of the market itself. In the present case there is no strong evidence that market expectations are actually wrong.

The second possibility is that the Central Bank undermines its own credibility by convincing the market that it will not maintain its inflation target. In the long run, after all, the Central Bank can determine the inflation rate and thereby the nominal exchange rate of the króna. However, such action would be perilous – it would overturn all the success that has been achieved in building up confidence in stability and interest rates would soar as risk premiums rose, and ultimately the real exchange rate would not be brought down at all. Thus the main consequence would be higher inflation.

The third option is to convince the market that the monetary stance will not come under as much strain as has been thought, because other economic policy instruments will bear a greater share of the burden. In order to do so, the best approaches are a credible government plan for fiscal countermeasures and an intention to use more foreign labour.