

Box 4 International comparison of short-term real interest rates

By maintaining a tight monetary stance, the Central Bank of Iceland has striven to ease overheating in the domestic goods and labour markets and thereby con-

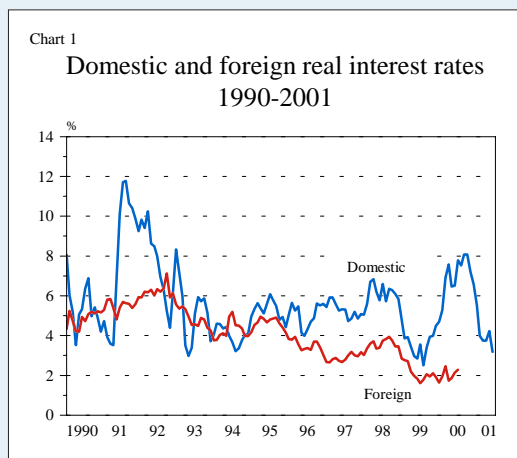
tribute to a low rate of inflation, in accordance with its stated inflation target. Monetary policy is implemented along similar lines to other countries which have

Periods of high real interest rates in selected OECD countries

<i>Country</i>	<i>Period</i>	<i>Real interest rate</i>	<i>Country</i>	<i>Period</i>	<i>Real interest rate</i>
<i>USA</i>	May 81 - July 82	7.6	<i>Italy</i>	Sept. 81 - January 82	6.6
	Nov. 82 - March 83	5.8		January 83 - April 97	6.7
	April 84 - October 84	6.6	<i>Canada</i>	April 81 - October 81	8.3
	October 85 - February 86	5.8		March 82 - Nov. 82	6.6
<i>Belgium</i>	March 81 - Sept. 81	6.2		Nov. 83 - May 85	7.1
	January 84 - January 88	6.6		December 85 - March 86	6.6
	Sept. 89 - Nov. 93	6.6		August 88 - December 90	7.3
<i>UK</i>	Sept. 81 - March 83	6.3		June 91 - April 92	6.5
	February 85 - October 87	6.8		April 94 - June 94	6.4
	February 89 - October 89	6.0		January 95 - April 95	5.8
	June 90 - October 92	7.1	<i>Portugal</i>	August 85 - Sept. 86	7.5
<i>France</i>	March 82 - Sept. 82	7.0		May 87 - October 87	6.7
	December 83 - August 84	6.0		May 94 - October 91	6.5
	February 85 - April 86	6.6		June 92 - January 93	6.3
	June 87 - January 88	6.0		May 94 - December 94	7.1
	February 89 - Sept. 93	7.3	<i>Spain</i>	Dec. 82 - Dec. 83	8.8
	March 95 - May 95	6.0		June 87 - March 88	8.4
<i>Greece</i>	August 87 - Nov. 87	6.7		December 88 - June 93	7.6
	February 93 - Sept. 95	8.1		January 95 - Nov. 95	6.2
	February 96 - Nov. 96	6.1	<i>Switzerland</i>	April 92 - July 92	5.9
	Nov. 97 - February 00	7.7			
<i>Iceland</i>	May 91 - February 93	8.4	<i>Sweden</i>	February 81 - June 81	5.6
	July 93 - Sept. 93	5.8		June 82 - October 82	6.4
	February 95 - August 95	5.6		July 84 - October 84	6.1
	Sept. 96 - March. 97	5.7		February 85 - March 87	7.7
	January 98 - Nov. 98	6.2	<i>Germany</i>	August 81 - Nov. 81	6.4
	February 00 - December 00	7.1		May 90 - March 91	7.0

The table shows periods when real interest rates exceeded 5.5% on average, using short-term money market rates. Real interest rates are calculated using inflation over the six-month period on either side of the reference date. Foreign data cover the period from January 1980 to December 2000. Data for Iceland cover the period from January 1990 to September 2001. Data before that period are not used, since interest rates in Iceland were not market-determined until the late 1980s and an organised money market was not formed until the early 1990s. Sources: IMF, *International Financial Statistics*, various publications and the Central Bank of Iceland.

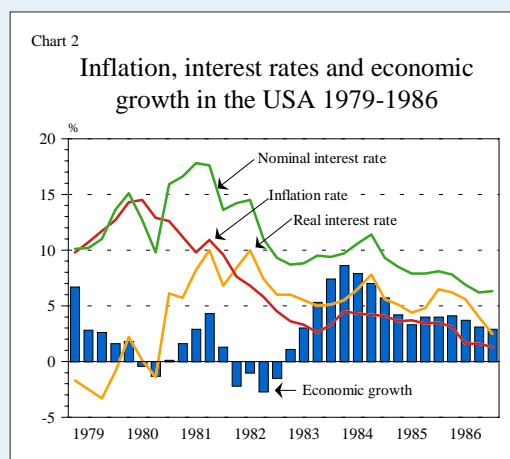
achieved good results in this field. Complaints are frequently heard about the Central Bank of Iceland maintaining high interest rates compared with those of central banks overseas. However, the higher interest rates which have prevailed recently are by no means unparalleled. Among other industrial countries, numerous examples can be found where policy rates have been raised for fairly long periods in response to domestic overheating, leading to short-term rates as high as those in Iceland at present, or even higher, as the table shows.



In fact, real interest rates were often considerably higher than the averages in the table would suggest. In Iceland, short-term real interest rates were high in the early 1990s. They were also fairly high in 2000 but have been falling in recent months, as revealed by the above chart which shows real interest rate developments in Iceland and the average rate of the countries in the table. The development of the real interest rate

1. The table is confined to industrialised countries where continuous data are available for the entire period.

in the USA is interesting. Around mid-1980 inflation in the USA was close to 15% in the wake of large oil price hikes in 1979, overheating of the US economy and a slack monetary stance. To counter overheating and bring down inflation, the Federal Reserve began raising its interest rates fairly fast in the second half of 1979. The Federal Funds rate was just under 7% at the beginning of 1978, but had risen past 15% in the first half of 1980. It peaked in the first half of 1981 at almost 18%. Real interest rates (on the same criterion as above) were negative in 1979, indicating a loose monetary stance. However, they rose rapidly and peaked in mid-1982 at 10%.



A tight monetary stance reflected in high real short-term interest rates gradually managed to combat inflation. The economy cooled rapidly and eventually a contraction took place, with real interest rates running very high by that time. In pace with decelerating inflation, the Federal Reserve eased the monetary stance by cutting short-term interest rates. A new growth period began in mid-1983 and lasted until the end of the decade without much inflation being generated.