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Responses to some of the proposals from the task force on the review of monetary policy

At the Monetary Policy Committee's (MPC) meeting earlier this month, the Committee discussed the Central Bank's forthcoming report to the Prime Minister concerning the Bank's position on the proposals presented by the task force on monetary policy pertaining to changes in working procedures of the MPC and the Bank more generally (Jónsson *et al.*, 2018). The Bank's position on specific proposals can be found below.

Although this document is formally presented by the Central Bank, the text it contains represents the results of discussions within the MPC and is supported unanimously by the Committee. All proposals discussed here pertain to matters under the purview of either the MPC or the Governor of the Central Bank. The task force made other proposals as well, but their implementation requires statutory amendment, ministerial involvement, and/or revision of the agreement between the Government and the Bank.

Proposal 6: *The Central Bank of Iceland shall use the Reserve Bank of New Zealand's traffic light system to create clear ground rules for decision-making and communication of information on foreign exchange market intervention. Furthermore, there is need for a clearer and more transparent sterilisation policy in connection with intervention. Moreover, the Bank shall publish its assessment of the equilibrium real exchange rate on a regular basis.*

This proposal actually centres on two separate issues: i.e., the foreign exchange market intervention policy and the publication of additional information on the Bank's assessment of the equilibrium real exchange rate.

(1) Intervention in the foreign exchange market

The task force recommends that the Central Bank adopt the “traffic light system” used by the Reserve Bank of New Zealand (RBNZ), and it calls for a clear, transparent sterilisation policy.

The Central Bank agrees that it is necessary to explain the views underlying the Bank’s foreign exchange market intervention as well as possible. The intervention policy may need to change over time, however, depending on the conditions prevailing in the economy and the financial system. The policy is discussed regularly by the MPC, which oversees intervention as a part of monetary policy. The intervention policy has also been explained in the Committee’s statements and in Central Bank publications. For a while, intervention was aimed at building up Iceland’s international reserves and mitigating the risk of an overshooting of the exchange rate during the prelude to capital account liberalisation, as was explained at the time. At present, however, the intervention policy aims at smoothing out excessive short-term volatility but does not pinpoint a specific exchange rate target. This has also been explained publicly.

In this context, it is appropriate to emphasise that there are limits on how predictable a central bank’s foreign exchange market intervention can be without creating the risk that market agents will corner the central bank and profit on unilateral speculation. Experience has shown that it can be risky for central banks to draw a line in the sand in this way.

In the Central Bank’s opinion, the suggestion that the Bank adopt the RBNZ’s traffic light system is worth examining more closely, but it needs to be thought out more fully and experiences from other countries should be considered as well. Conditions in New Zealand are entirely different than those in Iceland, as the New Zealand dollar is one of the most-traded currencies in the world. The foreign exchange market there is deep, and the Reserve Bank of New Zealand is less concerned about short-term volatility. In small countries, however, it is much more common that foreign exchange market intervention aim at mitigating volatility than it focus on a given exchange rate. This is also true of Iceland.

As regards sterilisation of foreign exchange market intervention via market transactions by the Central Bank, it should be noted that sterilisation is largely built into monetary policy instruments, as short-term market interest rates have deviated very little from the Bank’s key interest rate. This has been explained by the Bank, but it should probably be done more thoroughly.

The Central Bank will establish a working group whose task will be to submit recommendations to the MPC in H1/2019 on the intervention policy and information disclosure about its execution.

(2) Assessment of the equilibrium real exchange rate

The Bank reviews its assessment of the equilibrium real exchange rate while preparing each forecast and publishes the assessment regularly in *Monetary Bulletin* (most recently in Box 3 in *Monetary Bulletin* 2016/2). Furthermore, a historical assessment can be found in the Bank's QMM database, which is updated on the Bank's website following each forecast. The Bank has also been considering launching a new annual publication on Iceland's balance of payments, which would also contain further discussion of the equilibrium real exchange rate. In addition, the Bank intends to expand its research in this area and, in this context, plans to engage a foreign expert in H1/2019.

Proposal 8: *The Central Bank shall publish the policy rate path in Monetary Bulletin four times a year. In this way, it will be possible to strengthen market expectations and enhance transparency of the Bank's long-term interest rate policy.*

From the beginning of 2007 until the onset of the financial crisis in autumn 2008, the Bank published the policy rate path for its baseline forecast, together with confidence intervals. Early on, the publication of the interest rate path appeared to deliver results, in that market expectations concerning future developments in interest rates moved closer to the path in the baseline forecast, thereby strengthening the transmission of Central Bank rates to other interest rates (*Monetary Bulletin* 2007/3), but unclear ownership of the policy rate path seemed gradually to undermine the usefulness of publishing it. During the financial crisis, there were no premises for continued publication of the policy rate path, but when conditions normalised, it would have been possible to resume publication. By then, however, a multi-member Monetary Policy Committee with external members had been established, and the Committee was not convinced of the usefulness of publishing a policy rate path at that time. There are two primary reasons for this.

First of all, the forecast is prepared by the Economics and Monetary Policy Department, and it is the Bank and not the MPC that is responsible for it. The view has been expressed within the MPC that as long as this is the case, there is the risk that the conditions prevailing before the crisis will develop again; i.e., unclear ownership of the policy rate path could undermine the efficacy of publishing it. Furthermore, the

publication of a policy rate path that differs fundamentally from the majority view of the MPC could create greater uncertainty in the market and exacerbate uncertainty about future developments in interest rates if, for instance, the forward guidance from the MPC majority runs counter to the published path.

As Table 1 indicates, some central banks in advanced economies publish a policy rate path with their baseline forecasts, but they are still in the minority. In all instances where the policy rate path is published, the macroeconomic and inflation forecast is the forecast of those who make interest rate decisions, not central bank experts' forecast; therefore, there should not be any inconsistency between the published path and rate-setting authorities' expectations about future developments in interest rates.

It appears that if this step were taken in Iceland, it would be necessary to shift ownership of the Bank's forecast preparation to the MPC. It is not clear, however, how this would work in a situation involving external MPC members.¹ It is clear, however, that such a change would call for a fundamental change in the forecast preparation process and the external MPC members' involvement with it. The forecast preparation process would be lengthened considerably, and the interest rate decision, the forecast, and the decision on the policy rate path would have to be prepared much earlier than they currently are – and well before the publication of the interest rate decision and *Monetary Bulletin*. It also appears clear that this would require much more work from external MPC members, as well as more time spent by them in the Bank.² This could be expected to require additional staffing for forecast preparation and support of the MPC.

¹If this step were taken in Iceland, the Central Bank would actually become the first central bank to publish a policy rate path for an MPC with external members. Of the four central banks that publish a policy rate path, those in Sweden and the Czech Republic have internal members only. In the case of New Zealand, interest rates are formally determined by the Governor of the RBNZ alone, but there are plans to establish a monetary policy committee that will presumably include external members. In Norway as well, there are changes in the offing, but until now, the Governor of Norges Bank has decided the published interest rate path, even though interest rate decisions are taken by a multi-member committee that includes external members.

²This also gives rise to the question of how easy it would be to find outside experts with enough expertise to function as external Committee members if their participation required that they leave their full-time jobs.

Table 1. Information disclosure on future developments in central bank interest rates

Central bank	Arrangement
Australia	Does not publish own policy rate path ¹
US	Publishes individual committee members' assessment of interest rate outlook
UK	Does not publish own policy rate path ¹
ECB	Does not publish own policy rate path ¹
Japan	Does not publish own policy rate path ¹
Canada	Does not publish own policy rate path ²
Norway	Publishes conditional policy rate path as part of baseline forecast
New Zealand	Publishes conditional policy rate path as part of baseline forecast
Sweden	Publishes conditional policy rate path as part of baseline forecast
Czech Rep.	Publishes conditional policy rate path as part of baseline forecast ³

1. The forecast is based on forward interest rates, which can be determined from financial market rates, although forward guidance is sometimes provided. 2. The Bank of Canada bases its forecast on its own interest rate path, which is not published. Sometimes the BoC provides forward guidance, however. 3. The Czech National Bank's interest rate path which is published for three-month interbank rates.

Sources: Central bank websites and Hammond (2012).

The other reason for doubts within the MPC about the efficacy of publishing a policy rate path for the baseline forecast, at least at the present time, centres to a degree on a fundamental view of the nature of monetary policy during times of uncertainty. According to this view, monetary policy is not a “scientific” matter that can be solved using mathematical maximisation models, as is done in many textbooks. The uncertainty about many key variables is simply too great. Monetary policy is therefore more like risk management where an attempt is made to avoid costly errors. Publishing a policy rate path could suggest greater certainty than actually exists and could therefore be misleading.

An example of this is the uncertainty about the Bank's equilibrium interest rate. Of course, this uncertainty is not limited to Iceland during times when long-term real rates have gradually been declining and the equilibrium rate has probably been quite variable. The problem also centres on the fact that within the MPC, opinion varies greatly on what the equilibrium rate is, and members are concerned that publishing a single policy rate path would not help inform the market and the general public of probable developments in Central Bank interest rates.³

As Table 1 indicates, some central banks have used forward guidance to inform the market and the public of probable medium-term developments in interest rates instead of publishing a formal policy rate

³To address this, the US Federal Reserve Bank has opted to publish so-called dot plots showing individual committee members' expectations concerning future developments in interest rates and their long-term equilibrium. Opinion is divided on how useful this is, however, and taking such a step in Iceland would require a substantial investment in expert support for individual MPC members so as to enable them to prepare their own interest rate forecast (and thus their own macroeconomic and inflation forecast).

path.⁴ This forward guidance entails specifying that interest rates will develop in a given way if economic developments align with the forecast. Sometimes, it is even specified how much rates will change or what they will be at a certain point in the future. Furthermore, forward guidance varies in form and frequency, but in most instances it is used when it is considered particularly necessary (such as in the past few years, when interest rates have widely been at or near their lower bounds). The same applies to Iceland: If the MPC has considered it warranted, it has signalled clearly that interest rates will develop in a given way in the coming term. A recent example can be seen in the MPC statements from the second half of 2015, when the Committee raised rates and stressed that further rate hikes would be forthcoming, all else being equal, after inflation and inflation expectations began to rise in the wake of large pay increases that spring.

Transparency is an important premise for successful monetary policy. On the other hand, care must be taken to ensure that publishing a policy rate path will actually enhance transparency and predictability of monetary policy. On the whole, the Central Bank does not consider it appropriate to publish a policy rate path for the baseline forecast at the present time, but it does not rule out the possibility of doing so in the future.⁵ That said, it could be appropriate to examine whether the MPC's forward guidance could be further formalised and strengthened in some other way.

Finally, it is appropriate to stress that forward guidance or policy rate path publication as such is not a prerequisite for successful monetary policy. Successful monetary policy is based on forward-looking decision-making that responds systematically to economic conditions so as to ensure that inflation remains at target over the medium term. Therefore, "forward guidance" on future developments in interest rates consists of these systematic monetary policy responses. Circumstances could arise, however, where more detailed guidance on future developments in interest rates could enhance the impact of monetary policy, as has been the case in recent years, when central bank interest rates have been locked in at their lower bounds.

⁴In all instances, these interest rate forecasts are conditional, no matter whether they are based on forward guidance or a formal interest rate path; i.e., they depend on medium-term economic developments. As a result, they do not constitute a formal pledge (i.e., an unconditional forecast) of future developments in interest rates, although markets and the public sometimes misconstrue them as such.

⁵The foreign experts who were entrusted with assessing the monetary policy framework also recommend against publishing a policy rate path. See Andersson and Jonung (2018) and Honohan and Orphanides (2018).

Proposal 9: *The responsibilities of and support given to external Monetary Policy Committee members needs to be increased. Decision-making should be made more transparent with the publication of individual members' votes at the time of the decision. The Committee should give increased consideration to Delphic forward guidance in connection with interest rates.*

This proposal actually centres on two separate issues: first, expanding external MPC members' responsibilities and increasing the support provided to them, and second, further enhancing the transparency of monetary policy.

(1) Responsibilities of and support for external MPC members

MPC members bear responsibility for their decisions in that they must explain them publicly. By law, the MPC has submitted a twice-yearly report to Parliament, followed by a meeting with a Parliamentary committee to discuss the contents of the report. Often, one of the external MPC members has attended these meetings with the Governor and expressed his/her views there. Perhaps this channel for expression by external members could be formalised more fully. On the other hand, it is not in the Bank's power to decide to what extent MPC members attend Parliamentary committee meetings, and in recent years the MPC's time with the Economic Affairs and Trade Committee has grown increasingly shorter.

In response to the task force's suggestions on increased visibility and responsibility for external MPC members, the Committee has decided that beginning in 2019, external members will submit a separate annual report to Parliament after the full Committee's second report is sent. Thereafter, external members would be prepared to attend a Parliamentary committee meeting to discuss the contents of their report. Such an arrangement would give them a formal channel for clear communication of their own views on economic developments and monetary policy formulation.

Ever since the MPC was established, the Central Bank has attempted to provide external members with as much professional support as possible. During the prelude to each decision, all Committee members are sent a large volume of data, as well as appraisals and analyses. Members may also ask questions and request specific analyses. On the other hand, the Bank's Economics and Monetary Policy Department is relatively sparsely staffed, and the workload is heavy during each forecast preparation period.⁶ As a result, it can be difficult to respond to

⁶As is mentioned in the task force's report, the department's staff is small in international comparison. Edwards' (2018) appraisal of the Central Bank's monetary

requests from MPC members – internal and external alike – within the specified time frame.

As a result, the Bank has decided to expand the Economics and Monetary Policy Department staff by one employee who will assist external MPC members with analysis, presentations, and other matters. The job description will specify that support for external MPC members shall take priority but that otherwise the employee will participate in the department’s regular work.

(2) Enhanced transparency of monetary policy

Ever since the MPC began its work early in 2009, the minutes of its meetings have been published two weeks after each decision. This is a major departure from the previous arrangement and has greatly enhanced the transparency of monetary policy in Iceland.⁷ As Table 2 indicates, this has placed the Central Bank in a category with most other inflation-targeting central banks, although there are some that still do not publish minutes of their meetings.

As can be seen in Table 3, whether and when individual committee members’ votes are published varies greatly. The central banks in the US, UK, Japan, and Sweden have gone furthest in this respect, publishing the results of voting and each member’s vote in the MPC statement. The Czech National Bank publishes this information in the minutes of the meeting, and the central banks in Australia, Canada, New Zealand, and Norway do not publish voting results or individual members’ votes.⁸

Table 2. Publication of minutes

Central bank	Arrangement
Australia	Minutes published 2 weeks after decision
US	Minutes published 3 weeks after decision
UK	Minutes published concurrent with decision
ECB	Minutes published 4 weeks after decision
Japan	Minutes published 6-9 weeks after decision
Canada	Minutes not published
Norway	Short summary of minutes published on an irregular basis
New Zealand	Minutes not published
Sweden	Minutes published 2 weeks after decision
Czech Rep.	Minutes published 2 days after decision

Sources: Central bank websites and Hammond (2012).

policy framework notes in particular how much high-quality work this small department manages to do.

⁷International comparison shows that monetary policy transparency has increased significantly in Iceland in recent years and is now similar to that in, for example, Australia, the UK, Canada, and Norway. See Dincer and Eichengreen (2014) and Karen Áslaug Vignisdóttir (2016).

⁸This may change in Norway and New Zealand, however, where there are plans to establish monetary policy committees that may publish minutes and voting results.

The Central Bank of Iceland Monetary Policy Committee's arrangements are very similar to those in the Czech Republic, in that the voting results are published in the minutes of each meeting. In Iceland, however, the votes of individual members are not published until the *Annual Report* is released in the spring of the following year. The Bank agrees with the task force that it is appropriate to enhance monetary policy transparency in Iceland still further. The MPC has therefore decided that, beginning in 2019, each member's vote will be specified in the minutes of the meeting in question.

Table 3. Publication of individual MPC members' votes

Central bank	Arrangement
Australia	Does not publish information on individual votes
US	Individual members' votes published in interest rate announcement
UK	Individual members' votes published in interest rate announcement
ECB	Does not publish information on individual votes
Japan	Individual members' votes published in interest rate announcement
Canada	Does not publish information on individual votes
Norway	Does not publish information on individual votes
New Zealand	Does not publish information on individual votes
Sweden	Individual members' votes published in interest rate announcement
Czech Republic	Individual members' votes published in minutes

Sources: Central bank websites and Hammond (2012).

As regards the suggestion that the MPC consider Delphic forward guidance, reference is made to the discussion on Proposal 8 above.

Proposal 10: *The Central Bank shall contribute to increased information on monetary policy and the value of the inflation target, with the aim of enhancing the general public's understanding of the possibilities available and the limitations in place, and with the objective of contributing to greater consensus on policy.*

Transparency is an important premise for successful monetary policy. Transparency is no less important for enhancing understanding of the options available to monetary policy at any given time and of the reasons individual decisions have been made. Transparency is also an important foundation for the democratic authorisation that an independent central bank is granted to apply the instruments it has at its disposal, with the overall long-term interests of the country in mind.

Ever since the inflation target was adopted in 2001, the Central Bank has emphasised maximum transparency of its analyses, so that outside experts can assess the professional basis for the Bank's analysis and forecasting. On the other hand, it was clear that transparency about

monetary policy decisions was lacking at first. This changed significantly, however, when the Central Bank Act was amended in 2009 and the Monetary Policy Committee established. In addition to publishing the minutes of its meetings, the MPC is required to submit a twice-yearly report to Parliament and to attend open Parliamentary committee meetings twice a year. Monetary policy transparency has therefore increased markedly in the past decade (see Dincer and Eichengreen, 2014, Karen Áslaug Vignisdóttir, 2016, and Qvigstad and Schei, 2018).

Furthermore, the Bank has made a concerted effort to make the material it releases on monetary policy both more accessible and more comprehensible. The Bank's main publication on economic developments and prospects, *Monetary Bulletin*, has been made shorter, and metrics of its readability indicate that the text published there is easier for the public to understand than it was previously (see Thórarinn G. Pétursson, 2018).

It can therefore be said that the Bank performs well in communicating information to experts and explaining the premises for its decisions (see, for example, Honohan and Orphanides, 2018). The Bank has also sought ways to communicate more effectively with the public, including by using social media and by publishing articles on monetary policy and economic affairs in the press. Presentations on monetary policy and the economy are also held regularly at upper secondary schools and universities, as well as various non-governmental organisations. Moreover, the Bank regularly receives visits from a wide range of groups and gives presentations to them on its activities. On the other hand, the Bank agrees wholeheartedly with the task force that it needs to do a better job at educating the public about monetary policy and inflation targeting. This is actually a challenge for all central banks, and worldwide efforts to find new ways to explain monetary policy frameworks and decisions are underway. To some extent, this task has ended up on the back burner at the Central Bank in recent years, owing to the heavy workload related to crisis resolution, particularly the liberalisation of the capital controls. The Bank has already begun work aimed at improving this aspect of its activities, but it is clear that additional funding and staff will be needed for information and public relations work. This will be included in its budget for 2019.

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