Box IV-1

The effects of monetary policy on private consumption

It is sometimes suggested that the effects of the Central Bank's monetary policy on private consumption are negligible, as reflected, for example, in rapid private consumption growth in recent years despite tight monetary policy. However, those who consider monetary policy to be completely ineffective may be underestimating the short-term effects of structural changes in the economy on economic growth and overestimating their long-term impact on the effectiveness of monetary policy. The effects of the structural changes in recent years on disposable income and the households access to credit are considered in this Box. These are the two main driving forces of private consumption growth since 2003.

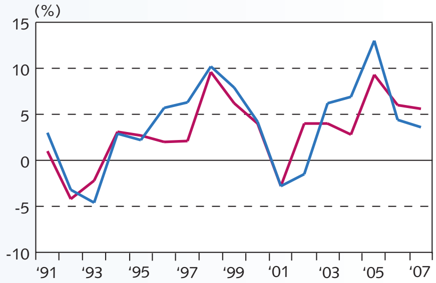
Structural changes contributed to rapid growth of disposable income ...

Real disposable income has increased rapidly in recent years despite the high rate of inflation. This increase may be attributed to major investment projects, the interaction between privatisation of the banks and reorganisation of the mortgage market, and tax cuts, at a time when the global supply of credit was unusually ample and international interest rates low. These conditions also made it possible for businesses to expand rapidly abroad. The result has been a large increase in wages, lower mortgage rates, and longer maturity of loans to households. The cut in income and consumption taxes reinforced the growth of disposable income.

The above conditions also contributed to an unprecedented increase in asset prices. It enabled households to increase their consumption by "collateralising" expected future income to a greater extent than before, in addition to increasing spending from substantially higher current income. The interaction of easier access to credit and expectations of a continuing growth of disposable income explains why private consumption increased beyond the growth of disposable income during 2003-2005. A major part of the increase during this period appears to have been driven by increased debt accumulation rather than by rising income. This was also the case when private consumption rose rapidly in the middle of the last decade (see Charts 1 and 2).

Chart 1

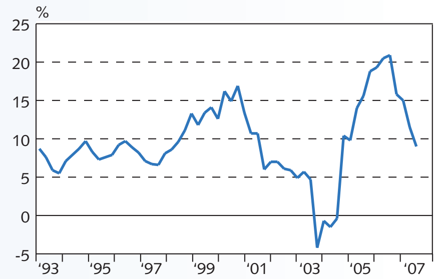
Private consumption and disposable income 1991-2007[1]



1. Central Bank baseline forecast 2007. Disposable income is the Central Bank's estimate.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

Household debt Q1/1993 - Q2/2007



Source: Central Bank of Iceland.

... and worked against the effects of monetary policy on private consumption ...

The fundamental changes noted above have offset the effects of monetary policy on private consumption in four different ways. First they contributed directly to increased growth of disposable income, as already noted. Second, they delayed the transmission of the effects of a higher policy interest rate across the yield curve relative to what would have been expected under normal circumstances. Interest rates on mortgage loans were on a declining trend for 1½ years after the Central Bank began to raise the policy interest rate and loan maturities were extended. Third, the structural effects contributed to easier access to credit, despite the rises in the policy rate by fuelling higher asset prices and thereby increasing the value of households' collateral. Finally, they increased the supply of foreign currency-denominated loans at low interest rates, thereby enhancing the expansionary effects of favourable circumstances in global financial markets.

... but the increase in disposable income and credit access will return to normal and the effects of monetary policy on private consumption will resurface

The above analysis suggests that the reason why the effects of the policy interest rate on private consumption appear negligible at first sight lies first and foremost in the combined magnitude of a set of shocks initiated by the government, which enhanced demand and thus offset the impact of monetary policy on private consumption, concurrently with greatly expanded access to credit and highly favourable conditions in global financial markets. However, structural changes of the magnitude observed in recent years are the exception rather than the rule, and their effects will gradually recede. Recently, long-term interest rates have risen and, in due course, housing prices will stop rising. The ability of households to increase private consumption beyond the growth of real disposable income through additional borrowing will then be curtailed. The effects of monetary policy on private consumption will become more apparent at this stage.

While it has been emphasised above that ultimately the policy rate will ulitimately affect private consumption and that the experience of the past few years is not unequivocal evidence to the contrary, there are still reasons to expect that the lag in the transmission mechanism will be longer and less predictable in Iceland than in most other countries. This is so for two main reasons. First, a substantial part of household debt is long-term, fixed real rate mortgages. As the Housing Finance Fund mainly issues bonds that span several business cycles to finance these mortgages, the effects of monetary policy on such long-term bonds will be less than on short-term bonds. Nevertheless, the effects appear not to be entirely absent, as indicated by the recent rise in interest rates on indexed long-term bonds (although circumstances in foreign financial markets may also have had an effect here). The policy rate also has strong effects on the debt service burden of short-term debt, even though it is a small part of household debt. As the supply of long-term credit diminishes, the weight of this transmission channel will increase.

Second, considering that an increase in the policy rate entails an appreciation of the króna's exchange rate, it may be argued that it has positive effects on the balance sheets and disposable income of households. The relative prices of imported durable consumer goods are temporarily reduced, thereby encouraging purchases of cars and other durable consumer goods that are usually credit financed. Exchange rate depreciation has the opposite effect. The positive effects on household balance sheets will be stronger the greater the share of their debt, which is either denominated in foreign currency or indexed to domestic prices. Since the exchange rate effects of an increase in the policy rate tend to be temporary in nature, the same is true of the effects on balance sheets. It is also important when considering recent developments that, in addition to the high exchange rate of the króna, asset price increases and their effects on households' balance sheet and access to credit, as explained above, have also encouraged purchases of durable consumption goods with borrowed funds.

The weights that are attached to these opposite exchange rate effects on household balance sheets are partly related to the impact a strong currency has on household expectations about future exchange rate movements. If exchange rate changes are expected to be reversed, with associated effects on inflation and thereby on outstanding indexed debt and disposable income, this should serve to make rational individuals averse to additional borrowing. However, the expectations of individuals may not be fully rational. If some degree of herd mentality is present, this transmission channel may be weakened. A transparent monetary policy can help by increasing the impact on private expectations. Accordingly, the Central Bank of Iceland has substantially increased its transparency.