

# CENTRAL BANK MONITORING – JUNE

Monetary Department  
Monetary Policy and Fiscal Analyses Division

2019

## IN THIS ISSUE

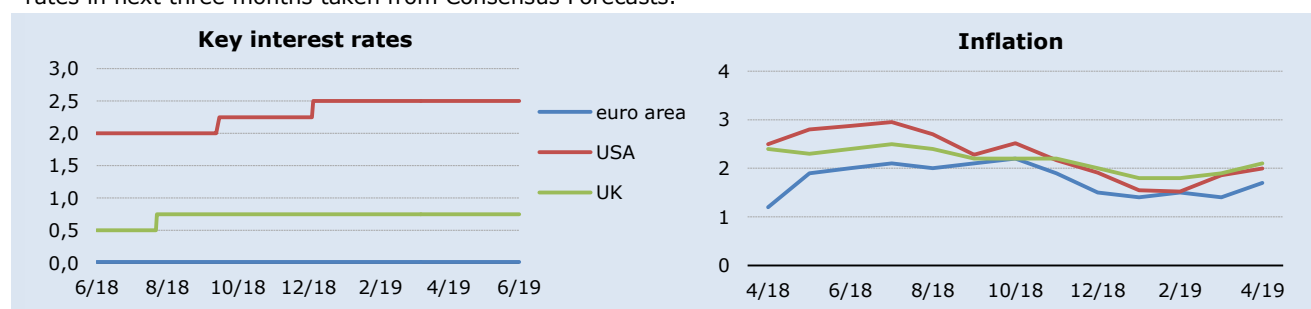
*Economic growth is slowing further across the economies we monitor and central banks forecast the slowdown to continue in the next two years. Inflation is fluctuating around central banks' inflation targets in all the economies under review except Norway, Switzerland and Hungary. However, banks proceed with monetary policy normalisation only slowly and mostly move it further into the future. New Zealand even cut its official rate, while Hungary and Sweden will start to buy bonds again. The ECB kept its key rates unchanged and moved the date for their possible first hike further into the future. It also specified the terms of its programme of targeted two-year refinancing operations (TLTRO III) to be launched in September 2019. Only the Fed is likely to raise interest rates, albeit at a slower-than-expected pace. Spotlight examines the banking sector crisis in Iceland. In our Selected speech, Bundesbank President Jens Weidmann explains the importance of supporting competition and dealing with the challenges of digitalisation to present-day monetary policy.*

## 1 LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

### Key central banks of the Euro-Atlantic area

	<u>Euro area (ECB)</u>	<u>USA (Fed)</u>	<u>United Kingdom (BoE)</u>
<b>Inflation target</b>	<2% <sup>1</sup>	2% <sup>2</sup>	2%
<b>MP meetings (rate changes)</b>	10 Apr (0.00) 6 Jun (0.00)	19–20 March <sup>5</sup> (0.00) 30 Apr–1 May (0.00)	21 Mar (0.00) 2 May (0.00)
<b>Current basic rate</b>	0.00%; -0.40% <sup>3</sup>	2.25–2.50%	0.75%
<b>Latest inflation</b>	1.2% (May 2019) <sup>4</sup>	2% (Apr 2019)	2.1% (Apr 2019)
<b>Expected MP meetings</b>	25 Jul 12 Sep	18–19 Jun <sup>5</sup> 30–11 Jul	20 Jun 1 Aug
<b>Other expected events</b>	12 Sep: publication of Eurosystem staff projections	Jul 2019: publication of Monetary Policy Report	1 Aug: publication of Monetary Policy Summary
<b>Expected rate movements<sup>6</sup></b>	→	→	→

<sup>1</sup> ECB definition of price stability “below but close to 2%”; <sup>2</sup> January 2012 definition of inflation target; <sup>3</sup> deposit rate; <sup>4</sup> flash estimate; <sup>5</sup> meeting associated with summary of FOMC economic forecasts; <sup>6</sup> direction of expected change in rates in next three months taken from Consensus Forecasts.



The **ECB** kept its rates unchanged but pushed back its possible first hike again. The ECB now expects rates to stay at their present levels at least through 2020 H1. It will keep reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme. The ECB specified the TLTRO III rate. The rate in each operation will be set at a level that is 10 bps above the average rate applied in the Eurosystem’s main refinancing operations over the life of the respective TLTRO ([for details see here](#)). Compared with March, the GDP growth outlook for 2019 rose slightly in June. The ECB expects GDP to rise by 1.2% (versus 1.1%) in 2019. By contrast, the growth outlook for 2020 is lower at 1.4% (versus 1.6%). It expects growth of 1.4% (versus 1.5%) for 2021. The inflation forecast is broadly flat. The ECB foresees inflation at 1.3% (versus 1.2%) in 2019 and 1.4% (versus 1.5%) in 2020.

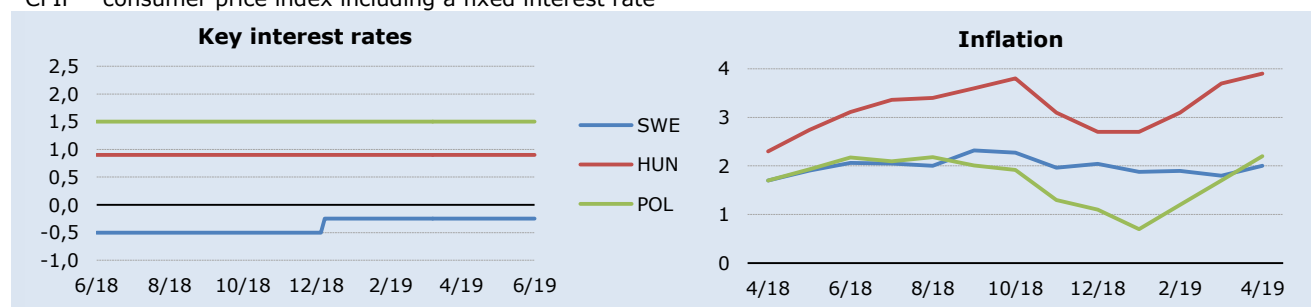
The **Fed** left its base rate at 2.25–2.50%. The minutes of the May FOMC meeting show agreement of its members on the need to maintain a patient approach to policy adjustments. The FOMC also dealt with the mechanisms that would best address a potential economic downturn and structure securities positions. However, no decision was made in this regard. According to the March 2019 FOMC macroeconomic projections, rates can be expected to remain stable until the end of 2019 (as against two 0.25 pp increases expected until recently). The market now even expects their slight decline. One rate increase can probably be expected in 2020. The FOMC expects slightly weaker GDP growth this year (2.1%) compared to the March forecast (2.3%). In 2020, it foresees GDP growth of 1.9%. Inflation is projected at 2% and the unemployment rate at 3.7%–3.9% in the next three years.

The **BoE** maintained its key rate at 0.75% and the stock of government and corporate bond purchases at GBP 435 billion and GBP 10 billion respectively. Quarter-on-quarter GDP growth is expected to reach 0.5% in Q1 and around 0.2% in Q2. The BoE expects higher volatility of data on economic activity due to Brexit-related uncertainties. Its current forecast predicts year-on-year GDP growth of over 2% in mid-2022. The BoE slightly lowered the rate outlook, expecting them to rise to 1% in mid-2022. However, its statement indicates that a future monetary policy tightening is regarded appropriate. Inflation fell to the target at the start of 2019, reaching 2.1% in April. It is expected to be slightly below the target in the middle of the forecast period due to a temporary slowdown in energy price growth. The BoE expects inflation at the target from 2020 and its fluctuation slightly above it in the rest of the forecast period.

## Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
<b>Inflation target</b>	2% <sup>3</sup>	3%	2.5%
<b>MP meetings (rate changes)</b>	24 Apr (0.00)	26 Mar (0.00) 30 Apr (0.00) 28 May (0.00)	2–3 Apr (0.00) 14–15 May (0.00) 4–5 Jun (0.00)
<b>Current basic rate</b>	-0.25%; -1.00% <sup>2</sup>	0.9%; -0.05% <sup>2</sup>	1.50%
<b>Latest inflation</b>	2.0% (Apr 2019)	3.9% (Apr 2019)	2.2% (Apr 2019)
<b>Expected MP meetings</b>	2 Jul 4 Sep	25 Jun 23 Jul 27 Aug	2–3 Jul 10–11 Sep
<b>Other expected events</b>	3 Jul and 4 Sep: publication of Monetary Policy Report	25 Jun: publication of Inflation Report	16 Sep: publication of Inflation Report
<b>Expected rate movements<sup>1</sup></b>	→	↑	→

<sup>1</sup> Direction of expected change in rates in next three months taken from Consensus Forecast survey; <sup>2</sup> deposit rate, <sup>3</sup> CPIF – consumer price index including a fixed interest rate



The **Riksbank** left its policy rate unchanged at -0.25% at its latest meeting. It also announced that the rate would remain at this level for a longer period of time than had been forecasted in February. Rates are thus expected not to be raised in mid-2019 but towards the end of the year or at the beginning of next year. The Riksbank will purchase government bonds totalling SEK 45 billion from July 2019 to December 2020. This corresponds to around half of the principal payments and coupons that the Riksbank will receive from the bond portfolio during this period. The purchases will take place in order to maintain an appropriate level of the portfolio and the Riksbank's presence in the market. The Riksbank kept its inflation outlook for the next three years broadly unchanged in its current forecast, expecting inflation of close to 2%. GDP grew by 2.3% in 2018. The Riksbank raised its GDP growth forecast for this year to 1.7% (from 1.3%). It expects growth of 1.9% next year and 1.8% in 2021.

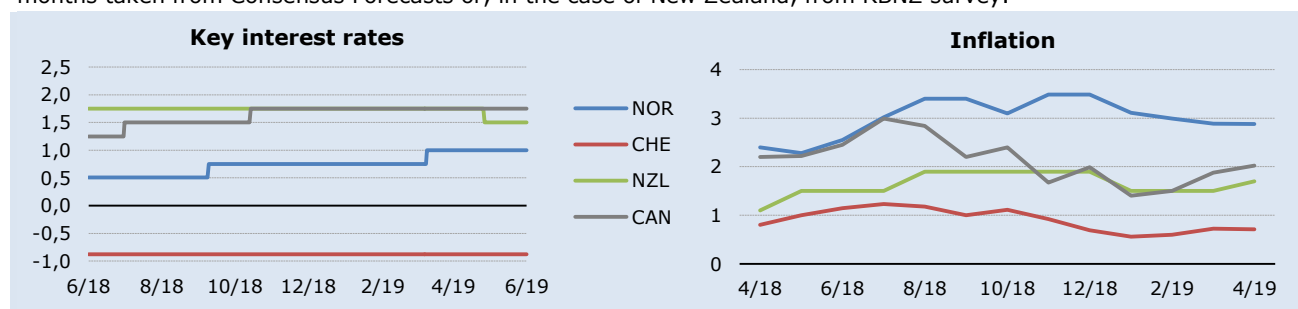
The **MNB** maintained its base rate at 0.9%. However, it raised its deposit rate from -0.15% to -0.05% in March. To increase the diversification of funding to the domestic corporate sector, the MNB will launch a [corporate bond purchasing programme](#) totalling HUF 300 billion on 1 July 2019. The aim is to improve the effectiveness of monetary policy transmission. Inflation rose to 3.9% in April and core inflation reached 3.8%. According to a preliminary estimate, the Hungarian economy grew by 5.3% in 2019 Q1. The growth was driven mainly by industry, construction and services. The MNB forecast expects economic growth to slow but remain strong.

The **NBP** kept its interest rate unchanged at 1.5% over the past three months. GDP growth remained buoyant in Q1 (4.7%). It continued to be driven by household consumption, fuelled by increasing employment, rapid wage growth and positive consumer sentiment. Investment, including a strong recovery in investment by corporations, also contributed significantly to GDP growth. According to the NBP forecast, GDP growth will slow gradually to 3.4% at the end of 2021. Household consumption will remain the main driver of GDP growth over the forecast horizon. Consumer inflation remains moderate, reaching 2.2% in April. The NBP forecast for this year expects inflation to hit the inflation target from below. Inflation will reach 2.7% in 2020 and slightly fall to 2.5% at the end of the forecast period.

## Other selected inflation-targeting countries

	<u>Norway (NB)</u>	<u>Switzerland (SNB)</u>	<u>New Zealand (RBNZ)</u>	<u>Canada (BoC)</u>
<b>Inflation target</b>	2%	0–2%	2%	2%
<b>MP meetings (rate changes)</b>	21 Mar (+0.25) 9 May (0.00)	21 Mar (0.00)	27 Mar (0.00) 8 May (-0.25)	24 Apr (0.00) 29 May (0.00)
<b>Current basic rate</b>	1% 0.00% <sup>1</sup>	from -1.25% to -0.25% <sup>2</sup> ; -0.75% <sup>3</sup>	1.5%	1.75%
<b>Latest inflation</b>	2.9% (Apr 2019)	0.7% (Apr 2019)	1.5% (2019 Q1)	2% (Apr 2019)
<b>Expected MP meetings</b>	20 Jun 15 Aug	13 Jun	26 Jun 7 Aug	10 Jul 4 Sep
<b>Other expected events</b>	20 Jun: publication of Monetary Policy Report	19 Jun: publication of Quarterly Bulletin	7 Aug: publication of Monetary Policy Statement	10 Jul: publication of Monetary Policy Report
<b>Expected rate movements<sup>4</sup></b>	↑	→	→	→

<sup>1</sup> Only on reserves exceeding the quota; <sup>2</sup> chart displays centre of band; <sup>3</sup> negative deposit rate on banks' account balances held at the SNB, graded according to balance amounts; <sup>4</sup> direction of expected change in rates in next three months taken from Consensus Forecasts or, in the case of New Zealand, from RBNZ survey.



As expected, the **NB** raised its policy rate by 0.25 pp to 1% in March. It also increased the rate on reserves in excess of banks' individual quotas by 0.25 pp to 0%. Based on the March forecast, the NB expects the policy rate to increase further in 2019 H2 and reach 1.75% at the end of 2022. The Norwegian economy grew by 2.5% in 2018 and is projected to rise by 2.7% in 2019. It will slow to 1% in 2022. A tight labour market suggests that wages will continue to grow. Inflation will reach the 2% inflation target from below at the end of 2022, while CPI-ATE (inflation adjusted for tax changes and excluding energy products) will hit the target from above.

The **SNB** left the target range for its monetary policy rate (3M LIBOR) unchanged in negative territory (i.e. between -1.25% and -0.25%). The rate on banks' account balances with the SNB was also flat at -0.75%. The SNB continues to reserve the right to intervene in the foreign exchange market as necessary. GDP growth stagnated in 2018 H2, but at a robust 2.5% rate recorded for the year as a whole. This year, the SNB expects GDP to expand by around 1.5%. The inflation forecast shifted lower for the entire forecast horizon. The SNB reduced the inflation outlook for 2019 from 0.5% to 0.3% and that for 2020 from 1% to 0.6%.

The **RBNZ** reduced its official rate by 0.25 pp to 1.5% in May. This was due to a need for a monetary stimulus to maintain maximum sustainable employment and meet the inflation target. Inflation stood at 1.5% in 2019 Q1. It is expected to reach the inflation target again in the medium term as cost pressures build up. Employment growth was 1.5% and the employment rate stood at 67.5% in March. According to the RBNZ, employment is close to a maximum sustainable level. GDP growth slowed in 2018 H2. According to the RBNZ forecast, the economy will expand at a rate of almost 3% this year. It will slow to around 2% in 2020.

The **BoC** maintained its key rate at 1.75%. Inflation was 2% in April. It will remain around the 2% target in the coming months. Core inflation indicators also stay close to 2%. The slowdown in GDP growth in late 2018 and early 2019 was only temporary, although risks related to the trade war have increased. In this context, the degree of monetary policy accommodation and interest rate levels remain appropriate according to the BoC. In the following periods, the Governing Council will pay attention especially to developments in household spending, oil markets and the global trade environment.

## 2. NEWS OVER THE LAST THREE MONTHS

### **RBNZ completed transformation of its monetary policy**

[Amendments to New Zealand's monetary policy framework](#) at the Reserve Bank of New Zealand (RBNZ) came into effect at the beginning of April. This completed the transformation to a new monetary policy framework extending the RBNZ's mandate to a dual one and establishing a Monetary Policy Committee (MPC) collectively responsible for making monetary policy decisions (previously the sole decision maker was the Governor). For more information about the RBNZ's new monetary policy framework see the [June 2018 CBM](#). The RBNZ also published a [Monetary Policy Handbook](#) that explains the new framework and sets out key assumptions about how the economy operates and about the contribution of monetary policy to New Zealand's economy.

The key components of the new framework are: (i) the [remit for the MPC](#) providing the MPC with its monetary policy and operational objectives consistent with the economic objectives in the Reserve Bank of New Zealand Act, which mainly requires the MPC to formulate monetary policy with the goals of maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment (the remit replaces the previous Policy Targets Agreements (PTAs) signed between the RBNZ Governor and the Minister of Finance); (ii) the [MPC charter](#) providing directions on decision making procedures, transparency and accountability of MPC members; the two documents were co-signed by the Minister of Finance and the RBNZ Governor; and (iii) the [MPC Code of Conduct](#) setting out minimum standards of ethical and professional conduct that must be adhered to by members of the MPC; this document was approved by the RBNZ Board of Directors.

According to the law, the newly established Monetary Policy Committee can consist of five to seven members; the [very first MPC](#) consists of seven members, four internal and three external. A non-voting [Treasury observer](#) also attends the MPC meetings. The first MPC meeting took place on 8 May and decided to reduce the Official Cash Rate (OCR).

### **ECB announces start date and new name for euro short-term rate (€STR)**

In March, the ECB decided to [change the acronym](#) of its overnight rate from "ESTER" to "€STR", and [announced](#) that the first €STR would be published on 2 October 2019. For more information about the €STR rate see the [ECB website](#) and the [September 2018](#), [June 2018](#) and [December 2017](#) CBM issues.

### **Philip Lane becomes ECB chief economist, Gabriel Makhlof to succeed him as new Governor of the Central Bank of Ireland**

In June, the incumbent Governor of the Central Bank of Ireland (CBI) Philip Lane became a member of the Executive Board of the ECB for eight years as ECB chief economist. He succeeded Peter Praet, whose mandate ended at the end of May. Lane was the sole candidate for the position. His candidacy was [supported](#) by the Eurogroup, [approved](#) by the ECB Governing Council at the beginning of March and [recommended](#) by the European Parliament in mid-March. He was [appointed](#) by the European Council at the end of March.

The Irish government made a surprising move and [nominated](#) Gabriel Makhlof as new CBI Governor in May. He currently works as Treasury secretary and chief economic and financial adviser to New Zealand's government, and he is also Treasury observer on the RBNZ's Monetary Policy Committee (see above). He previously also worked as a top UK civil servant and principal private secretary to then Chancellor of the Exchequer Gordon Brown. He will become the first non-Irish national to head the CBI (he was born in Egypt of British and Greek parentage).

Makhlof will take up the position of the CBI Governor in September; in the interim the Central Bank Commission [appointed](#) CBI Deputy Governor Sharon Donnery (initially considered a favourite for the position of Governor) as temporary Acting Governor of the CBI.

### **British government starts search for new BoE governor**

At the end of April, the British government published a vacancy [advertisement](#) for the Governor of the Bank of England (BoE) position as a replacement for Mark Carney, who will leave the job at the end of January next year. Mark Carney has headed the BoE since July 2013 and he is the first BoE Governor who is not a UK citizen (he is a Canadian). He was originally supposed to leave the job in June 2019, but

at the request of the Chancellor [agreed](#) to extend his term by half a year to help ensure smooth exit of the UK from the European Union (for more details see the [September 2018 CBM](#)). The new Governor will face the difficult task to continue to support the British economy in a situation of continuing uncertainty around Brexit. Among the possible candidates mentioned for this position are, for example, the head of the Financial Conduct Authority (FCA) Andrew Bailey, BoE Deputy Governor for monetary policy Ben Broadbent, BoE Deputy Governor for financial stability Jon Cunliffe, former Governor of the Reserve Bank of India (RBI) and current professor at the University of Chicago Raghuram Rajan, former BoE Deputy Governor for banking and market and current LSE director Minouche Shafik or former UK Secretary of State for business and current chair of Santander UK Shriti Vadera.

The British government also [reappointed](#) Ben Broadbent for a second term as Deputy Governor for monetary policy, i.e. until 2024. His reappointment will provide continuity as the government seeks a replacement for the BoE Governor.

### 3 SPOTLIGHT: ICELANDIC TURBULENCE

*Iceland is a volcanic island situated on the boundary of two tectonic plates. It is thus constantly geologically active and earthquakes or volcanic eruptions are not uncommon. However, Iceland was able to recover even from the worst of natural disasters after an eruption caused death of almost a quarter of the population in 1783. When hit by the global financial crisis, accompanied by strong economic and financial turbulence which almost decimated the Icelandic banking sector and brought the state to the brink of bankruptcy, Icelanders faced yet another challenge making them deal with adversity. This article goes back to the Icelandic story and describes, among other things, the subsequent necessary measures to restore the functioning of the Icelandic banking sector.*

#### **Iceland – general characteristics**

Like Czechoslovakia, Iceland became an independent state in 1918. However, it remained in a union with Denmark even after that year, declaring full independence in June 1944. The island has an area of around 100,000 km<sup>2</sup> (i.e. similar to Bulgaria) and a population of about 350,000. It is currently among the top 15 richest states as measured by GDP (PPP) per capita.<sup>1</sup> The Icelandic economy is small and open,<sup>2</sup> importing virtually all consumer goods. Iceland's exports of goods comprise mainly raw aluminium and fish and its main export markets include the countries of the European Union (the Netherlands, Spain, Germany, the United Kingdom and France), the USA, Norway, Japan and China. The total foreign trade balance is currently recording a surplus due to a sharp upswing in exports of services, tourism in particular. Iceland is not a EU member state although accession negotiations were held in 2009–2015. However, Iceland has strong links to the European Union thanks to its membership in the European Economic Area (EEA) and the Schengen area. It is also a member of the European Free Trade Association (EFTA).

#### **Iceland's financial sector and its liberalisation**

Iceland's financial sector was strongly regulated until the 1980s. Banks were owned by the state and politicians were members of their bodies; lending-related decisions were also under strong political pressure. The political landscape also affected the organisational structure of the central bank, which had three governors, one from each major political party.

The gradual liberalisation of the Icelandic economy and the financial market started in the 1980s and picked up in the 1990s after Iceland joined the European Economic Area (EEA).<sup>3</sup> Among other things, the three largest Icelandic banks (Glitnir, Landsbanki and Kaupþing), accounting for 85% of the banking sector, were privatised before 2003 as part of the liberalisation. With the benefit of hindsight, however, the result of the privatisation was not without problems since control over banks was gained by several large interconnected domestic investor groups. These groups soon launched a massive expansion of the banks abroad.<sup>4</sup>

The main feature of the banking expansion was the use of short-term loans in foreign capital markets to finance long-term loans of their owners (or interconnected firms) who invested these loans in shares in foreign firms and commercial property. This strategy was highly commercially successful in a period of easy access to financing in global financial markets. The size of banks grew geometrically: consolidated assets of the three main banks (i.e. including their foreign subsidiaries and branches) rose from 170% of GDP at the end of 2003 to 880% of GDP at the end of 2007 (thus to a relatively comparable level as observed in the banking sector in Switzerland or Ireland at that time).<sup>5</sup>

<sup>1</sup> The IMF and the World Bank rank it 13th (2018) and 14th (2017) respectively.

<sup>2</sup> Iceland's imports account for 44% of GDP and exports of around 47% of GDP.

<sup>3</sup> Many reforms were implemented as part of the liberalisation, which helped re-launch the Icelandic economy, such as tax cuts, state expenditure cuts, privatisation of state-owned companies, a change to the pension system, exchange rate easing, reinforcement of the central bank's independence, easing of the labour market, the goods market and the financial market.

<sup>4</sup> The largest expansion took place in 2004–2007. Icelandic banks aimed their activities mainly at the United Kingdom, Luxembourg and Scandinavian countries, where they had built and expanded further the activities of their branches. Deposits in branches were guaranteed by the Icelandic government, which became a problem during the financial crisis when the Icelandic government did not have funds to honour these guarantees.

<sup>5</sup> See e.g. OECD Economic Surveys Iceland, 2009, p. 20.

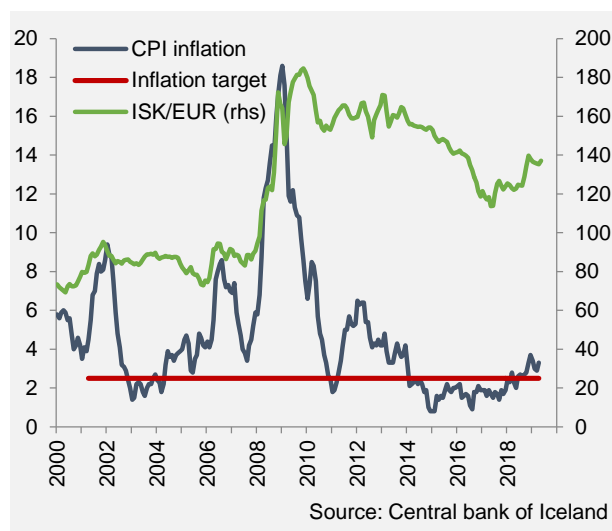
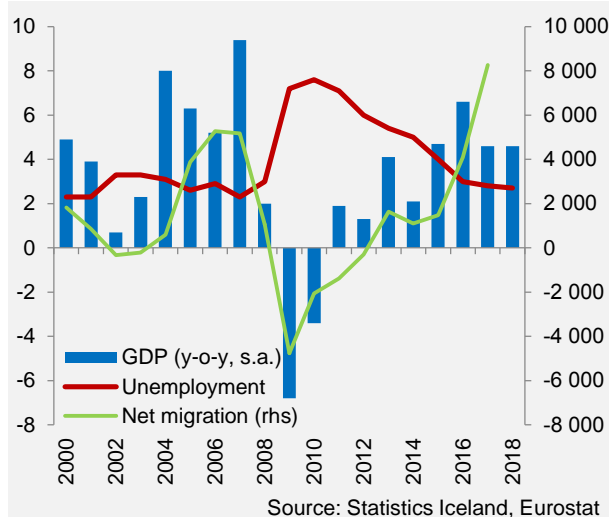


The number of loans provided by the aggressively expanding banks to Icelandic households and non-financial corporations also grew, at an average rate of 30% a year in 2003–2007.<sup>6</sup> Moreover, the ratio of households' foreign-currency debt increased (to 20% of loans in September 2008) since banks offered foreign-currency loans (denominated mainly in Swiss francs and Japanese yens) remunerated at a more favourable rate than Icelandic krona-denominated loans.

The liberalisation of the economy and the financial sector resulted in high economic growth, of more than 6% on average year on year in 2003–2007, accompanied by low unemployment (around 3%, see the chart). The shortage of labour was resolved by immigration, especially after new member states joined the European Union in 2004 (by contrast, the following crisis period saw an outflow of population).

### The Central Bank of Iceland and its activity before the bank collapse

The Act on the Central Bank of Iceland (Seðlabanki Íslands) was also amended during the liberalisation, aiming to depoliticise the central bank. Among other things, the government's previous easy access to financing by the central bank was limited and the bank's supervisory powers were strengthened (supervisory powers were transferred to a new independent supervisory authority Fjármálaeftirlitið, FME, in 1999; a merger of the central bank and the FME is currently underway, see below).



A new act on the central bank was issued in 2001, laying down the pursuit of price stability as its main objective.<sup>7</sup> In order to achieve price stability, the bank was entitled, with the consent of the prime minister, to adopt inflation targeting (it had targeted the exchange rate before) and a joint statement by the government and the central bank set the inflation target at 2.5%. If the average annual inflation differs from the inflation target by more than  $\pm 1.5\%$ , the bank is obliged to submit a public explanatory report to the government.

In the years of high economic growth, inflation rose from less than 2% in the first half of 2003 to an average level of 5.2% in 2003–2007, staying above the inflation target from 2004 (see the chart). The central bank increased rates in May 2004. Nevertheless, its policy was not, in retrospect, sufficiently strict.

The rate on seven-day collateralised loans to financial institutions was set as the key monetary policy rate.<sup>8</sup> Banks were provided with seven-day collateralised loans at this rate in the amount they requested. Banks started to make massive use of central bank lending mainly in 2006 and 2007 when they started to have financing difficulties in global financial markets. The amount of these loans rose from ISK 30

<sup>6</sup> Debt of Icelandic firms more than doubled between 2003 and 2007, amounting to almost 300% of GDP; debt of households rose by around one-third in the same period, to almost 400% of GDP.

<sup>7</sup> The act was amended in 2009. It put only one governor at the helm of the bank, who also chairs the new five-member Monetary Policy Committee (MPC). The act was amended in 2013 and the bank was also granted an explicit mandate of pursuing financial stability. The Financial Stability Council and the Systemic Risk Committee were established in 2014, headed by the Finance Minister and the Governor of the central bank respectively.

<sup>8</sup> This rate was in effect until April 2009. The rate which had the largest effect on short-term market interest rates has always been selected as the key interest rate since then. The current key monetary policy rate is the seven-day term deposit rate. For more information see the [website of the Central Bank of Iceland](#).

billion to ISK 500 billion from autumn 2005 to October 2008 (see the chart).<sup>9</sup> This increase also suggests that the interest rate was too low. However, the central bank increased it more significantly only in 2008 in response to a surge in prices. But the downside of higher rates was that they were used extensively by foreign investors and speculators who bought up the Icelandic krona, whose holdings offered high returns.<sup>10</sup>

At the end of 2007, the central bank started to draw the government's attention to the bad condition of the banking sector and its enormous size and also the increasing threat to the Icelandic economy if it collapsed suddenly. However, their meetings had no effect and produced no immediate measures.<sup>11</sup> The government considered it more substantial to prevent a bad reputation of Icelandic banks and did not give significance to the ratio of the size of the banking sector to that of the Icelandic economy. The central bank or the FME supervisory authority did not have sufficient powers to intervene.

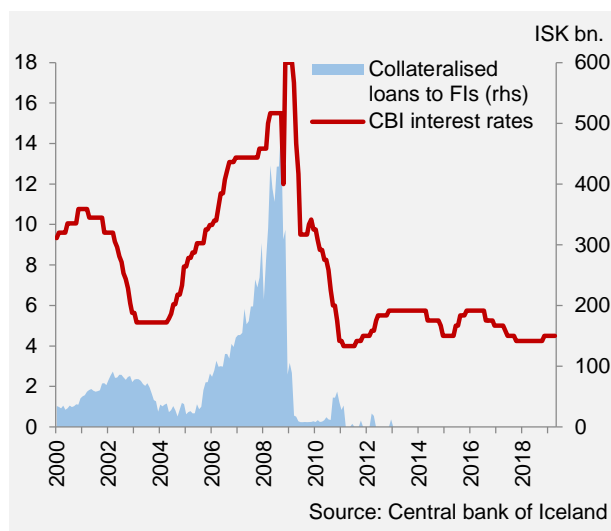
### The collapse of Icelandic banks and its resolution

The 2008 global financial crisis caused Icelandic banks to lose access to global financial markets, with their borrowing costs rising enormously. They were not able to refinance and repay their liabilities and were facing a collapse. The threat of a collapse of the banking sector gave rise to a rapid outflow of foreign speculative investment and a sale of the Icelandic krona, which caused its sharp depreciation. The Icelandic government and the central bank had to avert the collapse of the currency, among other things due to the huge volume of foreign-currency loans held by domestic entities without any collateral. Therefore, they took radical steps.

The government started to gradually take control over the major banks in autumn 2008. Repayment of foreign deposits was suspended (especially in the Netherlands and the United Kingdom), which caused a short diplomatic dispute between Iceland and the United Kingdom. In October 2008, trading in the Icelandic krona was suspended temporarily and capital controls were introduced to prevent a chaotic outflow of capital abroad and a fall of the Icelandic krona. The government obtained a loan of USD 2.1 billion from the IMF in November 2008. The IMF's stabilisation programme focused mainly on supporting the exchange rate, achieving fiscal sustainability and restructuring the financial sector.<sup>12</sup>

Successor banks were restructured fundamentally after nationalisation. Their domestic and foreign operations were divided. Domestic banking operations were transferred to new banks and remained almost unchanged. The government tried to protect the domestic economy in this manner. The sale of the sound parts of banks or the sale of assets and other holdings of these banks to cover claims of creditors or the state started in mid-2011. The government achieved an agreement with foreign creditors of banks in liquidation in 2015, including their consent to a write-off of part of the Icelandic krona-denominated assets.

In 2017, the Central Bank of Iceland started to implement a strategy consisting of several steps to lift capital and currency restrictions on payments and trading in the Icelandic krona. Foreign payments between abroad and Iceland could be made freely from March 2017. The Central Bank of Iceland discontinued the duty to create the Special Reserve Ratio (SRR) for investors in Icelandic bonds in March



<sup>9</sup> Further short-term secured loans amounting to around EUR 4.5 billion were provided to banks by the European Central Bank until autumn 2008.

<sup>10</sup> The key interest rate of the Central Bank of Iceland stood at 15% from March 2008, 15.5% from April to mid-October, while the interest rates of the BoE and the ECB were only 5.5% and 4% respectively.

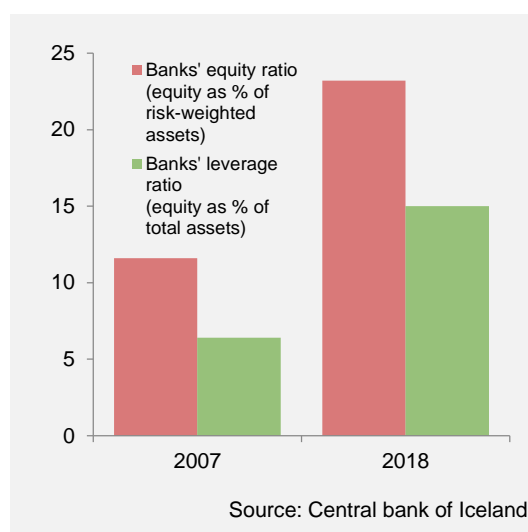
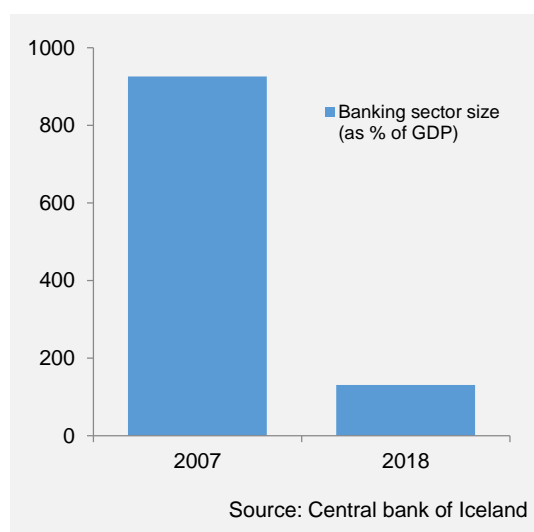
<sup>11</sup> It is often cited that one of the possible explanations for the absence of any reaction by the government to the reports submitted by the Governor was his previous political engagement as the Prime Minister for a competing political party that was in power at that time.

<sup>12</sup> Iceland completed the programme successfully in 2011 and even repaid the loan in 2015.

2019.<sup>13</sup> The only still applicable capital restriction prohibits trading in the Icelandic krona using the interest rate differential (i.e. carry trade) and trading in unsecured financial derivatives. It is aimed against an uncontrolled inflow of speculative capital. However, all restrictions are expected to be removed in future.

### Today's financial sector and supervisory authorities

Three nation-wide commercial banks currently operate in Iceland: Arion banki (a successor of the Kaupþing bank), Íslandsbanki (a successor of the Glitnir bank) and Landsbankinn (a successor of the Landsbanki bank), and about ten regional savings banks. The government sold the state participation in the Arion Bank in 2018, maintaining the 100% ownership of the Íslandsbanki and holding 98% of shares in Landsbankinn.<sup>14</sup>



Today's size of the Icelandic banking sector relative to GDP is consistent with the figures usual in most advanced countries and any assistance to banks in difficulties is thus more feasible from the government's perspective. Banks are also in a better condition than before the crisis: their capital adequacy ranges between 20% and 25% of risk-weighted assets, significantly above the regulatory minimum (16%). Banks' behaviour is also less risky, so they are much better prepared to face unfavourable circumstances.

This notwithstanding, Iceland is yet to take measures to improve the situation in banking supervision and regulation. One of them, recommended for numerous years by international organisations such as the IMF and the OECD, is to establish sufficiently independent banking supervision vested with the necessary powers and with sufficient funding. Icelandic authorities have followed the recommendation recently and the Parliament is currently discussing a bill on integrating banking supervision (i.e. the existing financial supervisory authority FME, which reports to the Ministry of Finance at present) into the central bank.<sup>15</sup>

Iceland has thus saved and restored its financial sector, but its small, open and rather specialised economy might be affected by relatively small shocks. An example may be the current situation where a cooling in tourism and a collapse of an airline company combined with a bad fishing season resulted in the central bank's radical re-assessment of the economic outlook this year from GDP growth of 1.8% to a decline in GDP of 0.4%.<sup>16</sup> Icelanders must thus remain alert because their island will always remain exposed to the external environment.

<sup>13</sup> The SSR rate prescribed for the reserve requirement was imposed on the inflow of capital to the Icelandic bond market and high-yielding deposits in June 2016. It was aimed at moderating the flows and affecting the structure of foreign capital flowing to the Icelandic market. The SSR was reduced from 40% to 20% in November 2018 and from 20% to 0% in March 2019.

<sup>14</sup> The goal of the government is to fully privatise the Íslandsbanki in the period ahead and to hold around one-third of the state participation in the Landsbankinn in the long run. The government intends to use income on the sale of state participations in banks to redeem government debt.

<sup>15</sup> See information on the [FME website](#) or on the [website of the Icelandic government](#).

<sup>16</sup> See the [Statement](#) of the Monetary Policy Committee of 22 May 2019.

#### 4. SELECTED SPEECH: MONETARY AND ECONOMIC POLICY CHALLENGES

*According to Jens Weidmann, President of the Deutsche Bundesbank, promoting competition and dealing with the challenges of digitalisation are important tasks that should be addressed by current economic policy. In his May [speech](#) in Düsseldorf, he further explained their importance to monetary policy.*

Bundesbank President Jens Weidmann sees current economic policy challenges in maintaining competition and in digitalisation. Functioning competition is the heart and soul of the social market economy. It prevents the concentration of welfare gains in the hands of a very few and instead allows consumers and workers a share of the spoils. However, it is not only a matter of distribution. Competition also guarantees the ability of the market economy to perform, motivating firms to develop new products or more efficient processes. In this context, it is disconcerting to see growing market power of firms in the United States, affecting various macroeconomic trends. These firms have raised their mark-ups, while the share of labour income in national income has dropped. At the same time, productivity gains have suffered. Even though the situation in Europe is different, we should keep these factors in mind. A study by the Bundesbank found no evidence of a long-term increase in price mark-ups in large European countries. European integration is likely to have made a contribution to this, as the single market has led to intensified competition. Coupled with strict competition law, this has contributed to making European markets less concentrated today than those in the US. According to Mr Weidmann, European competition oversight thus should not be called into question, as it helps all to benefit from the single market.

A competitive framework, nevertheless, needs to evolve in order to be effective in the digital age as well. A central business model of the digital economy is characterized by platforms that are provided by all major internet companies. Markets in the platform economy, however, have a tendency to become concentrated, owing to returns to scale and the attractiveness of linking a large number of users and data. Antitrust regulators thus will have to pay particular attention to these problems. On the other hand, digitalisation provides opportunities to boost competition, for example by allowing easy price comparison. A study by the ECB concludes that the increasing use of online trade in the EU has reduced inflation.

Digital transformation, however, has not yet resulted in a significant increase in productivity, which is perceived as a paradox. While optimists believe that the new technologies only need more time for their impact to unfold, pessimists are of the opinion that their growth potential is smaller than during earlier waves of innovation. Still, it is clear that digitalisation involves profound structural change presenting both risks and opportunities. Using the example of Germany, Jens Weidmann shows its challenges to economic policy: the need to expand fast internet connection, reforms to simplify the starting and closing of a business, support of basic research and innovation or a reform of corporate taxation.

There are many ways to improve the long-term outlook for growth. They all have one thing in common, though: they are in the hands of policymakers and beyond the reach of central banks. It is up to economic policy to strengthen potential growth. This would also ease the pressure on monetary policy. For stronger potential growth correlates with a higher level of the natural real interest rate and – with given inflation expectations – a correspondingly higher nominal interest rate level. An increase in the gap between the nominal interest rate and its lower bound will widen the scope for conventional interest rate policy. This reduces the likelihood of monetary policymakers having to resort to non-standard measures.

The topic of monetary policy flexibility has gained importance in the euro area over the past few years, given that low inflation has been an after-effect of the previous crisis. In order to ensure that inflation returns towards its target over the medium term, monetary policy became extraordinarily accommodative – including by means of non-standard measures. However, an extremely accommodative monetary policy stance cannot go on forever, as it entails risks and side-effects. One is that financial market actors tend to take greater risks in search of higher yields. In the real economy, low interest rates are connected with unproductive use of resources, as the very favourable financing conditions can keep afloat unprofitable firms. Current research is also warning that low rates could be a feeding ground for higher market concentration, as large, more highly leveraged firms in particular benefit from them.

In conclusion, Mr Weidmann recalls Hayek's words that competition may have unpredictable results. The state should not attempt to pre-empt them. Instead, it should give people the opportunity to use their creativity, to be successful in their efforts and to partake in the prosperity of the society.

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