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ADVICE TO SMALLER ADVANCED ECONOMIES[7]

CONTEXT

Very liquid international market conditions generated by UMP of the major central banks led other AEs to take innovative monetary policy actions. Denmark was the first to adopt negative interest rates (a move later emulated by Sweden and Switzerland), the Czech Republic and Switzerland introduced exchange rate floors, and Canada and Sweden went in different directions on the use of monetary policy to address financial stability risks.

The Danmarks Nationalbank (DN) pioneered the introduction of negative policy interest rates in response to surging capital inflows. In 2011–12, market fears about euro area breakup induced large flows into Danish krone-denominated assets, threatening the hard peg with the euro that the authorities were determined to maintain. When the ECB deposit rate was lowered to zero in July 2012, the DN followed by lowering its repo rate to −0.2 percent. This was the first time any central bank had posted negative policy interest rates. The DN lowered its policy rate again to −0.75 percent in early 2015 when removal by the Swiss authorities of their exchange rate floor led to renewed speculative pressure on the Danish krone. When inflows continued, the Danish authorities adopted a more aggressive and open-ended intervention policy, combined with an announcement that they would cease issuing government bonds, which had the desired effect of reversing the capital flows.

The Swiss National Bank (SNB) faced sustained downward pressure on consumer prices amid strong capital inflows and it responded in September 2011 by announcing a "floor" on the value on the Swiss franc/euro rate to help maintain price stability.[8] At the start of the GFC, safe-haven seeking capital inflows pushed the euro value of the Swiss franc progressively higher, despite countervailing action by the SNB, including a sharp initial reduction in policy interest rates, outright purchases of domestic bonds, and currency intervention. When the Swiss franc surged almost to parity with the euro in August 2011, the SNB decided on a dramatic change of regime, announcing a floor of 1.20 on the Swiss franc/euro rate and committing to unlimited interventions to defend this floor, which remained in effect for over three years.

The Czech Republic also innovated in its exchange rate policy in the face of concerns about deflation with policy interest rates having already been at the efective lower bound for some time. The Czech authorities lowered their policy rate to near zero by November 2012. When inflation did not recover and the outlook was towards more deflation, the Czech National Bank (CNB) adapted its floating rate regime to introduce an exchange rate ceiling in November 2013, declaring this to be an "additional monetary policy instrument," rather than a target, which remained the inflation rate. The introduction of the ceiling, accompanied by massive interventions in the amount of approximately 7.5 billion euro, led to an initial

[7] This chapter draws on Everaert (2019) and Honohan (2019).

[8] The term "floor" reflects the convention according to which the exchange rate is quoted in Swiss francs per euro, thus imposing a floor means to place a maximum value on the Swiss franc.

depreciation of about 5 percent. With inflation coming back on target, exit from the ceiling was accomplished smoothly in April 2017. The subsequent appreciation of the currency has not been excessive.

A key issue in Sweden was balancing its inflation targeting framework with financial stability concerns. Following a path different from other central banks, the Riksbank tried to manage financial stability risks by gradually tightening monetary policy during 2010–11. The Riksbank board decided that, despite high unemployment and low inflation, interest rates must be raised for "longer-term considerations," namely, financial stability concerns arising from a credit-fueled boom in the Swedish property market. However, the appreciation of the kronor and weakness of the euro area economy began to take a toll on the Swedish economy, and inflation kept coming in below target and below forecast. The Riksbank reversed course in July 2014 by cutting the policy rate and it moved to negative interest rates in early 2015. Inflation, which had dipped to zero or below, began to return towards the target, reaching 2 percent by early 2017.

In contrast to the Swedish approach in 2010–13, Canada has consistently chosen to use macroprudential policies instead of monetary policy to manage financial stability risks. During 2010–17, Canadian agencies tightened macroprudential policies related to the housing and credit markets. Key measures included tightening standards for government-backed insured mortgages (which cover the bulk of mortgage lending) and capping debt service-to-income ratios for mortgage lending. More recently, some provinces introduced property transfer taxes on nonresidents to deal with perceived speculation and support affordable housing in certain large city markets. Monetary policy has not been considered as a tool to actively lean against the wind and would only be brought to bear if all other options were exhausted (Poloz, 2015).

IMF ADVICE

IMF engagement with these five countries under review varied considerably in depth and content. Given their smaller size and more limited systemic reach, advice was largely through bilateral surveillance, particularly the Article IV consultation, and received less attention in multilateral surveillance or high-level Fund-wide processes.

IMF staff reacted after the fact to the novel Danish monetary policy actions, and attention to monetary policy issues remained comparatively light. There was limited interaction between the DN and IMF staff in advance of the introduction of negative rates, and subsequently the Fund's role was largely one of validation. The Policy Notes for Article IV consultations did not emphasize monetary policy issues and were matter-of-fact about the introduction of negative interest rates. In the 2012 Policy Note, staff remarked that "the negative interest rate policy is new and little experience has been accumulated, so any policy recommendation would be tentative. A note on this topic is planned for the SIP."[9] The 2012 Article IV Report (IMF, 2013a) devoted less than half a page to monetary policy in this environment and the Nordic Regional Report published by the European Department in 2013 (IMF, 2013e) devoted almost no attention to monetary policy issues. Not until 2014 did the Article IV report attempt a broader assessment of UMP-related issues in Denmark. However, within months of that report, Denmark's UMP strategy was challenged again by the Swiss floor exit (IMF, 2014f). There is no evidence of the Fund discussing contingency planning for Danish monetary policy in response to a potential Swiss exit. The government debt management announcement was, for example, entirely homegrown.

Engagement with the Swiss authorities on their use of the exchange rate "floor" was more intense. The SNB did consult the Fund on a range of possible policy options prior to introducing the "floor" in September 2011. After the event, a key challenge for the Fund was to decide whether to support the SNB's action to put a limit on the exchange rate's appreciation at a time of a large current account surplus, which led to external criticism.[10] In the end,

[9] Batini and others (2013) explored briefly some of the technical aspects of negative interest rates.

[10] The Swiss current account surplus has been running at about 10 percent of GDP since the mid-1990s, prompting allegations by Bergsten and Gagnon (2012) and Gagnon (2014) that Switzerland is a "currency manipulator," using policy tools to weaken the Swiss franc. Since 2016, Switzerland has been included in the monitoring list by the U.S. Treasury Department in its semi-annual review of currency practices. See also Taylor (2018).

IMF staff judged the “floor” to be an appropriate response to ensure price stability and deter capital inflows and not an attempt to manipulate the currency for competitive advantage. The Swiss authorities pointed to a number of distinctive features of the Swiss economy that tend to swell the current account surplus and Fund staff have given Switzerland the benefit of the doubt on this matter, noting that the insensitivity of the Swiss current account surplus to large fluctuations in the exchange rates suggests that special factors are at play. The staff position was supported by the fact that the Fund’s external balance assessment pointed to the Swiss franc being overvalued rather than undervalued.

IMF staff also supported the introduction of the exchange rate “floor” by the CNB and subsequently characterized it as “pathbreaking.” During the run-up to the policy shift, Fund staff had already been discussing with the authorities the modalities of a strategy of foreign exchange (FX) intervention to ward off deflation. In the 2013 Article IV consultation, staff advised that regular, pre-announced, and fixed-size interventions would be the best way “as they would prevent the perception that the CNB has a target exchange rate in mind.” Even though the “floor” was not the style of intervention they had suggested, the Article IV report recommended keeping it in place “until deflation risks recede” after considerable internal debate (IMF, 2013g).[11] IMF working papers (Alichi and others, 2015; Clinton and others, 2017) carefully explained the Czech method, characterizing it as “pathbreaking” and a potential model for other countries.

The focus in discussions in Sweden was squarely on the ongoing debate about the use of monetary policy to address financial stability concerns. As with the U.K. case, IMF staff publicly supported the Riksbank’s policy actions all through this period, although there was some internal questioning, including whether to support the Riksbank’s decision to lean against the wind. Review departments were concerned about the impact of tightening on the economy and suggested greater reliance on macroprudential policies. However, these views did not carry the day and the Fund publicly invariably supported the majority position within the Riksbank. When the Riksbank changed course in 2014, so did the IMF, with the 2015 Article IV Report characterizing the new monetary policy stance as “appropriate” (IMF, 2015b).

In Canada, the Fund’s focus was again on financial stability issues, with particular concern centering on the housing market. Overall, the Fund consistently agreed with the Bank of Canada that macroprudential tightening was preferable to monetary policy tightening to manage financial stability risks and to avoid “leaning against the wind.” From 2010 onward, every staff appraisal in Article IV reports approved of the macroprudential measures taken by the authorities to cool housing markets, advising greater tightening of these measures if they did not have the intended effect. By 2016, the IMF judged that “macroprudential policy has been broadly effective in alleviating financial stability risks” (IMF, 2016c). However, there were differences in view with regard to application of the IV on capital flows as the Fund assessed that some measures taken in response to housing price pressures treated foreign investors differently than residents and should be classified as CFMs, and suggested alternative measures. Canadian authorities did not agree with the characterization of provincial nonresident property transfer taxes as they were narrowly targeted to address excessive demand for housing, including from foreign investors, in two urban areas and were not introduced to target capital flows. Their effect on aggregate capital flows was likely minimal, given Canada's high degree of capital account openness.

ASSESSMENT

Central bank officials in the smaller AEs generally found Article IV consultations stimulating and useful even though these consultations did not greatly influence their novel policy decisions. Officials noted that, when they looked for external advice on monetary policy issues, they would typically first turn to counterparts at other central banks and to experts at the BIS with whom they had regular contact in committee and working group meetings. The value of the Article IV consultation came from the opportunity they provided to discuss monetary policy issues as part of the overall macroeconomic framework with well-informed external experts. Moreover, although

[11] Though Fund staff were not involved in the decision to introduce the floor or the design of the details, the IMF’s modeling team had in the past contributed to building the CNB’s analytic capacity to implement inflation targeting.

Fund staff had not anticipated or recommended initiatives taken by some of these central banks, the Fund's analysis and public support of these actions after they were taken was regarded as providing helpful validation.

- The Czech authorities in particular noted that a long association with Fund research staff on inflation targeting and related modeling issues prior to the GFC had a positive cumulative impact on their capacity for monetary policymaking. They were thus comfortable making the policy and operational decisions about the entry and exit from the exchange rate floor on their own. Nevertheless, they appreciated Fund support for their decisions and regarded discussions with the Fund on intervention strategies as useful even if in the end Fund advice had not been adopted.
- Likewise, though the Fund had not anticipated or recommended the exchange rate "floor" in Switzerland, the Fund's support was valuable in countering some critiques both within and outside the Fund that the country was a "currency manipulator." The Fund's analysis of the specific factors contributing to the very large Swiss current account surplus was also helpful to the authorities.
- Danish officials followed a long internal process of discussing the feasibility of negative interest rates and consulted "selectively" with people at other institutions. They did not approach the Fund for advice but some conversations about negative interest rates took place on the margins of the regular Bank-Fund meetings. Officials sensed that the Fund might find it difficult to be very supportive of negative interest rates until enough evidence had accumulated on their effects.

The Fund was not proactive in extending the policy toolkit for the smaller AEs. Arguably, intellectual curiosity and the global trend, already evident pre-crisis, towards lower neutral real interest rates should have prompted more exploratory work at the Fund on effective tools for small open economies for monetary stimulus close to the effective lower bound. As central banks in these economies experimented with new approaches, the Fund had little analytical material to bring to bear. It was also quite slow in publishing reviews of emerging experience with the new instruments. The Fund did provide a "positive view of negative interest rates" in 2016 (Viñals, Gray, and Eckhold, 2016) and reviewed the experience of countries in a Policy Paper presented to the Board in 2017 (IMF, 2017a)[12] but these papers were issued four years after the Danish action, and after it had already been emulated by several other central banks.

The Fund tended to be quite deferential to the central bank's majority view, sometimes leading to inconsistencies in advice across countries. For example, both Sweden and Canada had recovered quickly from the initial effects of the GFC and faced buoyant housing markets. Despite the emerging corporate view at the Fund in favor of not leaning against the wind, the Fund supported the majority view at the Riksbank to use monetary policy to cool housing markets, even as it staunchly supported the Bank of Canada's decision not to use monetary policy for this purpose.

[12] For comparison, the World Bank's *Global Economic Prospects* included a box on negative interest rates in June 2015 and a detailed study for the Board in July 2016.