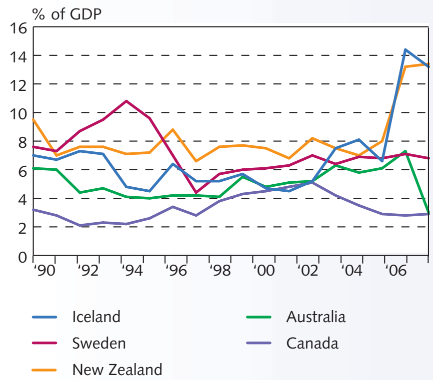
Box 1

The Central Bank of Iceland's foreign exchange reserves

Chart 1

Foreign reserves 1990-2007

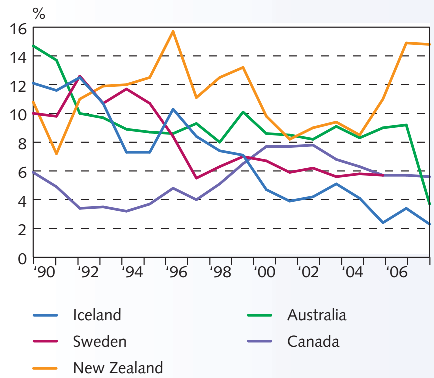


Source: IMF.

Chart 2

Foreign reserves of foreign debt

1990-2007

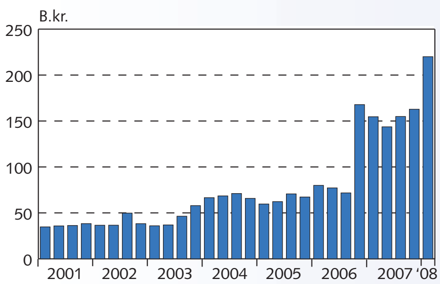


Source: IMF.

Chart 3

Foreign reserves of the Cental Bank of Iceland

Quarterly data



Source: Central Bank of Iceland.

Most central banks maintain foreign exchange reserves to some degree. The purpose of holding foreign reserves can vary; therefore, there are no rules or generally accepted criteria concerning their minimum size.[1]

Foreign reserves increased through regular currency purchases

In the fall of 2002, the Central Bank began purchasing foreign currency on the domestic currency market according to a pre-announced schedule.[2] Since then, the Bank has purchased over 2 billion US dollars on the domestic interbank market in regular increments. Initially, the purchases were used to repay the Bank's foreign short-term debt. That process was completed in mid-2003. Thereafter, they were used to repay foreign Treasury debt, with the result that net foreign Treasury debt is now zero. In a sense, this represents an indirect foreign reserve fund, in that a debt-free Treasury with an acceptable credit rating generally has ready access to global credit markets. Regular currency purchases were discontinued at the end of March 2008 because of the conditions on the foreign exchange market. They will resume as soon as market conditions permit.

Foreign reserves increased dramatically through foreign borrowings

The Central Bank's foreign reserves increased from 7 b.kr. in mid-2001 to 60 b.kr. in the fall of 2006. Towards the end of that year, a foreign loan was taken at the Central Bank's behest, with the aim of fortifying the reserves. This doubled the Bank's foreign exchange reserves. A Box in *Financial Stability* 2007 (p. 46) discussed the strengthening of the foreign reserves and the points of view taken into account at that time.

Access to foreign liquidity enhanced with swap agreements

In May 2008, the Central Bank concluded a bilateral currency swap agreement with three Nordic central banks, for a total amount of 1.5 billion euros. These swap agreements are essentially the equivalent of foreign reserves. Including the agreements, the foreign reserves now total 3.5 billion euros, or 400 billion Icelandic krónur. Because the Central Bank is not carrying any foreign debt at present, its foreign reserves have expanded from 7 b.kr. to approximately 400 b.kr. since mid-2001. The Government wishes to strengthen the foreign reserves still further, and work is being done to carry this out.

1. Appearing in *Monetary Bulletin* 2005/3 was an article by Haukur C. Benediktsson and Sturla Pálsson on central banks' foreign reserves, explaining, among other things, the purpose of maintaining foreign reserves.
2. During the first half of 2000, the Central Bank of Iceland's foreign exchange reserves totalled just over 30 b.kr. In the middle of that year, the Bank began intervening in currency market trading in order to counteract the depreciation of the króna that had begun in the spring. In order to preserve the foreign reserves, the intervention measures were funded with short-term foreign loans. As a result, the Central Bank's foreign currency balance deteriorated sharply, falling to only 7 b.kr. in mid-2001. The Bank's final intervention in the currency market took place in the fall of 2001. In an article appearing in *Monetary Bulletin* 2003/1, Gerdur Ísberg and Thórarinn G. Pétursson discussed in detail the intervention and its effect on the exchange rate of the króna. Their conclusion was that the effect was rather limited.