



Annual Report 2006

ANNUAL REPORT 2006

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Board of Governors.

Left to right: Ingimundur Friðriksson, Davíð Oddsson (Chairman), Eiríkur Guðnason.

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- . Not applicable.

I Objectives and policy

The main objective of monetary policy is price stability. The Central Bank of Iceland Act (No. 36/2001) includes a provision that the Bank's main objective is to promote price stability. By agreement with the Prime Minister, the Central Bank may declare a numerical target for inflation. In the joint declaration by the Government of Iceland and the Central Bank of Iceland on March 27, 2001, an inflation target was set for the Bank, i.e. a rate of inflation, measured as the twelve-month increase in the CPI, of as close to 2½% as possible.¹ Furthermore, the Act states that the Central Bank shall promote the implementation of the economic policy of the government as long as it does not regard this to be inconsistent with its main objective of price stability. The Bank shall also undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and secure financial system, including payment systems domestically and with foreign countries. In other words, the Bank shall address tasks concerning financial stability. The Act furthermore clarified provisions on accountability, transparency of monetary policy and the Bank's activities in general.

Monetary policy

Monetary policy implementation is based on the Central Bank's inflation forecast, made over a horizon of nine quarters and presented in *Monetary Bulletin*, published three times a year. Alongside the inflation forecast, the Bank publishes its own macroeconomic forecast and a detailed analysis of economic and monetary developments and prospects.

Until the end of 2005, the Central Bank did not follow a prearranged schedule for interest rate fixing decisions, apart from publishing a detailed explanation of its monetary policy decisions – whether or not these involved a change in the policy interest rate – in *Monetary Bulletin*, which was published four times a year at that time. At the beginning of 2006, the Bank adopted a formal calendar for its interest rate decisions. Initially it announced that there would be six scheduled dates, three of them coinciding with the publication of *Monetary Bulletin*, and that the Board of Governors may change the policy interest rate between the scheduled dates if it considers that there are grounds for doing so. Two interest rate decision dates were added in 2006, making a total of eight during the year. Each of the additional dates was announced on the preceding interest rate decision date. Towards the end of the year the Board of Governors announced six interest rate decision dates for 2007. It retains the right to add others if warranted. In accordance with the provisions of the Central Bank Act, the Board of Governors has laid down internal rules on the preparation, rationale and presentation of its monetary policy decisions.²

1. The declaration was published in *Monetary Bulletin* 2001/2 and on the Bank's website. A minor change was made in the wording in November 2005.

2. Published on the Central Bank website.

The Bank's main instrument is its policy interest rate, i.e. the rate of interest on the liquidity facilities that it provides to credit undertakings through collateral loans. Auctions of collateral loans with a maturity of one week are held on a weekly basis.

The Central Bank sets a minimum reserve requirement for credit undertakings equivalent to 2% of specified liabilities with a maturity of less than two years.

Financial stability

The Central Bank seeks to have a constant, clear overview of the position of credit institutions and financial markets. It publishes a regular analysis of factors affecting financial stability which includes an in-depth examination of both macroeconomic and aggregate microprudential indicators. Until 2004 this was published twice-yearly in *Monetary Bulletin*. In 2005 the Bank launched *Financial Stability* as a separate report which is published once a year.

As authorised by law, the Central Bank has set rules on minimum liquidity of credit undertakings and on their foreign exchange balance. In 2006, the Board of Governors announced a decision defining the Central Bank's financial stability functions.³

In special circumstances when the Central Bank deems it necessary in order to preserve confidence in the domestic financial system, it is authorised by law to issue guarantees to credit institutions which are in liquidity difficulties or grant loans to them other than those classified as regular transactions. In addition, the Central Bank promotes an efficient and secure financial system by evolving Icelandic payment and settlement systems in line with internationally recognised standards. The Central Bank cooperates on financial stability issues with the Financial Supervisory Authority (FME) on the basis of a cooperation agreement made with reference to legislation on the Central Bank and on official supervision of financial operations.⁴ In 2006 a Memorandum of Understanding was also signed between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, Financial Supervisory Authority and Central Bank of Iceland, on consultation concerning financial stability and contingency plans.⁵

Other functions

By law, the Central Bank has the sole right to issue bank notes and coin. It maintains and invests Iceland's foreign reserves. The Bank cooperates and conducts business with international institutions in its field of activities, including serving as a financial agent with the International Monetary Fund on behalf of the State.

Accountability and transparency

No less than four times a year, the Central Bank is obliged by law to give a public account of its monetary policy and monetary, exchange rate and foreign exchange developments, and its measures in these

3. Published on the Central Bank website. See further the discussion in Chapter IV.

4. Published on the websites of the Central Bank and FME.

5. Published on the Central Bank website. See further the discussion in Chapter IV.

areas. The Central Bank also issues an annual report in which it explains its activities in detail.⁶ The Central Bank strives to explain its activities to the fullest possible extent. This includes the assumptions underlying its monetary policy decisions, its assessment of financial stability and many other aspects of its activities. Transparency and accountability are also ensured with defined tolerance limits for the inflation target. This entails that, if inflation deviates by more than 1½ percentage point from the target, the Central Bank is obliged to submit a report to the Government explaining the reasons for the deviations from the target, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. This report shall be made public.

6. A list of Central Bank of Iceland publications in 2006 is on p. 56 of this Annual Report.

II Monetary policy and economic developments

In 2006 the Icelandic economy was characterised by imbalances on a greater scale than for many years. Indications of imbalances included production far in excess of estimated capacity, labour shortages, a record current account deficit and inflation far above target.

The main task of monetary policy during the year was therefore to tackle inflation, the result of imbalances that were driven by investments in the power and aluminium sectors and changes in the financial sector in recent years. In March, estimates for domestic demand, and particularly investment, in 2004 and 2005 were revised sharply upwards. In 2006 domestic demand growth also appears to have outstripped earlier forecasts. The króna depreciated rapidly in the spring as well. Thus the inflation outlook took a marked turn for the worse in the first half of the year. In response, the Central Bank raised its policy interest rate seven times in 2006, by a total of 3.75 percentage points to 14.25% by the end of the year. Since the Central Bank embarked on the current cycle of hikes in May 2004, the policy rate has been raised by 8.95 percentage points.

Inflation far in excess of target

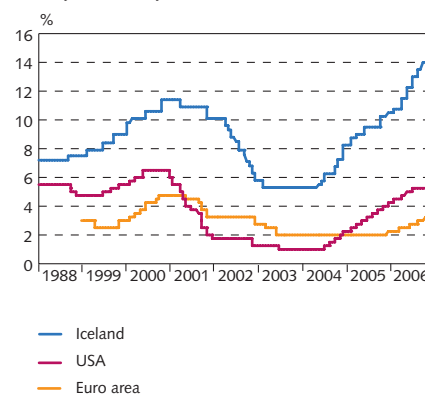
Average inflation in 2006 measured 6.8% and had been above target since May 2004. It gained pace over the first half of the year and the twelve-month increase in the CPI peaked in August at 8.4%. Subsequently, inflation slowed down to finish at 7% over 2006. The composition of inflation changed considerably in the course of the year. In 2005, the appreciation of the króna prevented rapid demand growth and soaring unit labour costs from driving up goods prices. With the depreciation in the first half of 2006, however, goods price inflation accelerated, but was offset by slower rises in housing prices, which had been the main driver of inflation the year before.

Wage rises by far outstripped productivity growth

The labour market was under strong pressure in 2006 and tightened progressively during the year. Excess demand for labour was met to a large and increasing extent with imported labour, which probably dampened wage drift. Nonetheless, wage increases were far above a level compatible with the inflation target. In the private sector, a wage review was agreed in July granting sizeable rises on top of those already scheduled under the 2004 settlements. The depreciation of the króna in the spring boosted businesses' profits and wage capacity. At the same time it improved their competitiveness against imported goods and services and made it easier for them to pass on wage rises to prices, since demand growth was still quite firm. The inflation outlook worsened as a result, with average wages rising by 10.5% in the second half of the year and the króna slipping by more than 21% from November 2005 to June 2006.

Chart II-1
Central bank policy interest rates

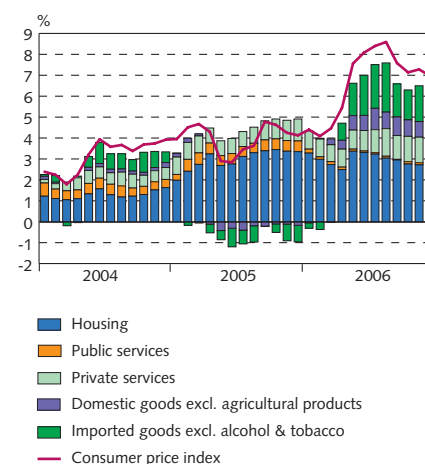
Daily data January 1, 1998 - December 29, 2006



Sources: Reuters EcoWin, Central Bank of Iceland.

Chart II-2
Components of CPI inflation

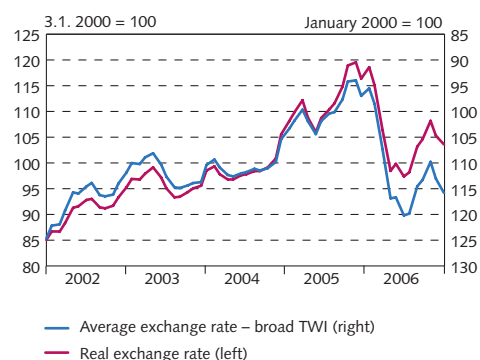
Contribution to inflation 2004 - 2006



Source: Statistics Iceland.

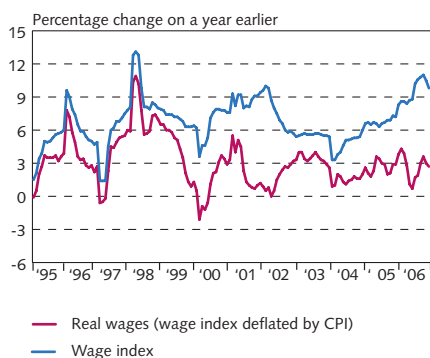
Chart II-3
Nominal and real effective exchange rate of the króna 2002 - 2006

Monthly averages



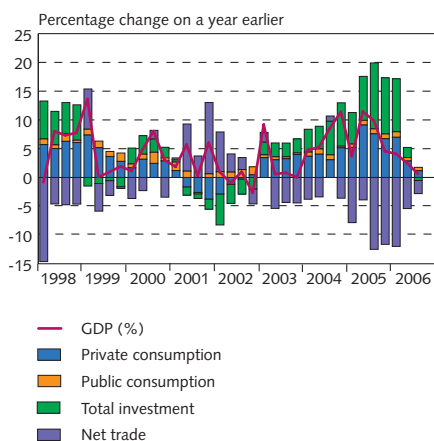
Source: Central Bank of Iceland.

Chart II-4
Nominal and real wages 1995 - 2006
Statistics Iceland wage index



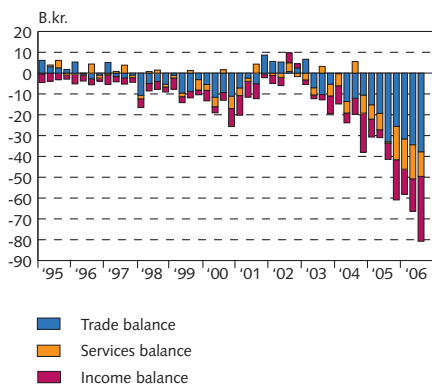
Source: Statistics Iceland.

Chart II-5
Contributions to GDP growth
Quarterly data



Source: Statistics Iceland.

Chart II-6
Components of current account
Net current transfer is included in factor income



Source: Central Bank of Iceland.

Robust Central Bank response

The deterioration of the inflation outlook in the wake of the depreciation of the króna and excessive wage rises required a vigorous monetary policy response. From June to September the Central Bank raised its policy interest rate by 1.75 percentage points and added one interest rate decision day to the preannounced schedule. Tightening monetary policy undoubtedly played a major part in preventing wage rises, which were far in excess of productivity growth, from causing an even greater surge in inflation. The widening interest rate differential with abroad bolstered the króna, which regained some of its former strength in the second half of the year. The long-run outlook for the króna, however, turned increasingly uncertain.

Wide current account deficit

The current account deficit widened as the year wore on, heading for roughly one-quarter of GDP for the year as a whole. Although almost one-third of the deficit derives from investment in the power and aluminium sectors, it was far too wide to be considered sustainable. Iceland's debt accumulation in recent years is also reflected in a growing income account deficit, which reached a record level in 2006.

The wide external deficit leaves the economy highly dependent on the willingness of foreign investors and creditors to fund it. One reflection of this was the volatility of the króna during the year, apparently largely driven by developments in international finance markets. This sensitivity towards external shocks is also shown by the exchange rate turbulence that foreign reports on the Icelandic economy sometimes prompted. Unrest was particularly pronounced in February and March. Carry trade slumped as a result, but rallied around the middle of the year, in line with the global trend. Fears of unease surrounding the maturity of large foreign glacier bond (króna-denominated Eurobond) issues proved unfounded.

Glacier bond issues dampened the impact of policy rate hikes

One challenge faced by monetary policy during the year was soaring carry trade. Foreign investor demand for króna-denominated bonds had a sizeable impact on the transmission of monetary policy, diverting much of the effect into the exchange rate channel. Coupled with massive changes in the Icelandic financial sector, this external impact caused long-term real interest rates to move in the opposite direction to the policy rate for a long time after the cycle of hikes began in May 2004. In addition, a surprise depreciation of the króna early in 2006 drove up inflation and inflation expectations, causing an unintended easing of the monetary stance. The Central Bank's strong policy response eventually reversed this trend towards the end of the year when estimated long-term real interest rates firmed sharply. However, the pending cut in VAT in March 2007 complicated measurement of exactly how much long-term real rates would rise.

Inefficiencies in the money market

Inefficiencies were also seen in the transmission of monetary policy measures to the shortest end of the yield curve. Money market liquid-

ity was ample until the autumn, but it began to tighten in the second half of the year due to the growing Treasury deposit with the Central Bank, which amounted to more than 110 b.kr. at the end of the year. Occasionally, money market rates went as high as the Central Bank's overnight lending rate, or even higher. Part of the problem may have been a lack of eligible bonds to serve as collateral for Central Bank lending facilities.

Among the positive effects of the glacier bond issues was a surge in turnover in domestic financial markets. Turnover more than doubled in the FX market and almost doubled in the króna market. This bolstered price formation, and the markets deepened and proved able to handle the much larger trading volume smoothly.

Monetary policy implementation is under continuous review. The Central Bank made considerable changes in the preparation and presentation of its inflation forecasts in 2006, partly in connection with the application of new models. This ongoing development work is also one aspect of the Central Bank's efforts to enhance monetary policy communication, aimed at anchoring inflation expectations at the inflation target.

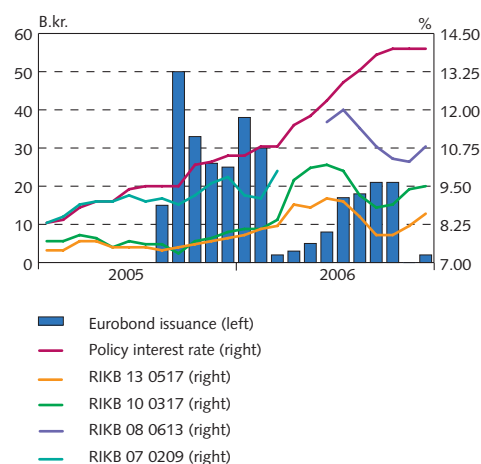
Economic and monetary development are described and analysed in detail in *Monetary Bulletin*.

Table II-I. Central Bank of Iceland policy rate changes in 2006

Decision date	Change
January 26	+ 0.25 percentage points
March 30	+ 0.75 percentage points
May 18	+ 0.75 percentage points
July 6	+ 0.75 percentage points
August 18	+ 0.5 percentage points
September 14	+ 0.5 percentage points
November 2	Unchanged
December 21	+ 0.25 percentage points

Source: Central Bank of Iceland.

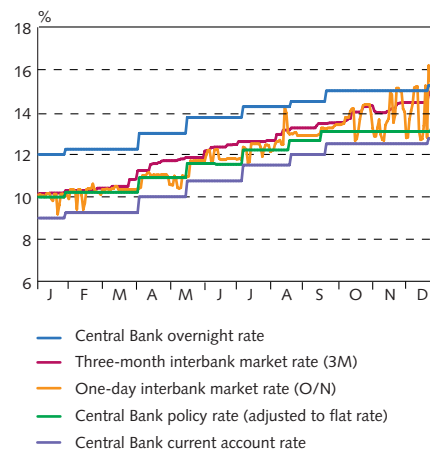
Chart II-7
Króna Eurobond issuance and interest rates
August 2005 - December 2006¹



1. Data until December 29, 2006 inclusive.
Sources: Reuters, Central Bank of Iceland.

Chart II-8
Interest rates in the interbank market and
Central Bank policy rate

Daily data January 3, 2006 - December 29, 2006



Source: Central Bank of Iceland

III The financial system

Financial companies

Promoting an efficient and safe financial system

In performing its mandatory role of promoting an efficient and safe financial system, including payment systems domestically and with foreign countries, the Central Bank of Iceland focuses on assessing the risk of illiquidity among financial companies and problems in payment and securities settlement systems which could be systemically important. It also promotes the efficiency and positive development of the financial system. In its work the Central Bank has taken into account international agreements and other standards for best practices along with the work of leading central banks in this field. The Central Bank cooperates closely with the Financial Supervisory Authority (FME) on financial stability tasks, on the basis of an agreement between them.¹ In light of the increasing prevalence of banks with cross-border establishments, the central banks of the five Nordic countries have signed a memorandum of understanding (MoU) on managing financial crises.

Financial stability broadly hinges upon “the stability of the key institutions and markets that make up the financial system. This requires (1) that the key institutions in the financial system are stable, in that there is a high degree of confidence that they continue to meet their contractual obligations without interruption or outside assistance; and (2) that the key markets are stable, in that participants can confidently transact in them at prices that reflect the fundamental forces and do not vary substantially over short periods when there have been no changes in the fundamentals.”²

Financial stability report

Once a year, the Central Bank publishes *Financial Stability*. The purpose of the report is to promote informed dialogue, strengthen risk management and explain how the Bank carries out its mandatory tasks in this field. The finding of the Central Bank’s analysis in May 2006 was that in spite of rapid expansion and the macroeconomic imbalances that need to be tackled in the coming years, the Icelandic financial system was broadly sound in the sense of being equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks appropriately.

Spotlight on commercial banks’ market funding

Rapid expansion in recent years has increased the importance of foreign funding for Iceland’s commercial banks and made them dependent on smooth access to international capital markets. Uncertainties

1. Published on the Central Bank of Iceland website.

2. Crockett, Andrew (1997), Why is Financial Stability a Goal of Public Policy? in *Maintaining Financial Stability in a Global Economy*, a Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 7-36.

about their market funding loomed at the end of 2005 when their CDS spreads and finance costs in international markets began to rise. A spate of negative reports about the Icelandic economy and banks was published early in 2006 and Fitch Ratings lowered Iceland's sovereign outlook from stable to negative in February. The króna slipped quite sharply as a result, equity prices dropped and doubts arose about the banks' ability to secure funding for loans maturing in 2006 and 2007. The banks responded with improved communication about their activities and reforms in various areas that had come under criticism, as well as slowing down their expansion and boosting capital adequacy. This turbulence prompted them to ply capital markets elsewhere than in Europe, especially in the US, with a raft of issuance, other borrowing and increased deposit-taking. By the end of 2006 the banks had funded their debt service for 2007 and built up strong liquidity which strengthened their profile among international analysts.

During this unease, the Central Bank closely monitored the funding and liquidity of the largest commercial banks. It made regular checks of their position with respect to its own criteria over the period from November 2005 to November 2006. At the same time the Central Bank undertook an exceptional level of communication to financial companies and institutions in other countries. Reflecting this climate, the *Financial Stability* report was more comprehensive than otherwise.

A joint contingency exercise with the FME was held in January 2006, along similar lines to the first exercise in January 2004. Aimed at the financial markets, it tested communications within and between the Central Bank and the FME. In February 2006, formal consultation

Table III-1. Moody's ratings of Icelandic commercial banks at end of 2006

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>	<i>Financial strength</i>
Kaupthing Bank	October 2006	A1	P-1	C
Glitnir	October 2006	A1	P-1	C+
Landsbanki	October 2006	A2	P-1	C

Table III-2. Fitch's ratings of Icelandic commercial banks and Straumur-Burðarás Fjárfestingabanki investment bank at end of 2006

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>	<i>Individual</i>	<i>Support</i>
Kaupthing Bank	August 2006	A	F1	B/C	2
Glitnir	August 2006	A	F1	B/C	2
Landsbanki	February 2006	A	F1	B/C	2
Straumur-Burðarás Fjárfestingabanki	January 2006	BBB-	F3	C/D	3

Table III-3. Standard & Poor's ratings at end of 2006

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>
Glitnir	June 2006	A	A2

was established between the Central Bank, the FME and the Office of the Prime Minister, Ministry of Finance and Ministry of Commerce on contingency plans for financial market shocks.³

International agencies assess the credit ratings of Iceland's three large commercial banks, i.e. Kaupthing Bank, Glitnir and Landsbanki, and Straumur-Burðarás Fjárfestingabanki investment bank. The Republic of Iceland, Housing Financing Fund, Landsvirkjun (national power company) and Orkuveita Reykjavíkur (Reykjavík Energy) also have international credit ratings. Ratings become increasingly important for the banks, the more that they raise funding in the markets. Tables III-1, III-2 and III-3 show their credit ratings.

Robust position of commercial banks

Profitability was very strong at the three largest commercial banks in 2006. The main explanations for their robust profits were increased interest income following strong lending growth, large income from fees and commissions and substantial gains on equity portfolios. Customer delinquency was also at a low. In 2006, almost half the banks' income was generated outside Iceland.

Assets of the three largest banks grew by more than 3,000 b.kr. (56%) from the beginning to the end of 2006. Part of this growth was generated by the depreciation of the króna and higher inflation. Lending to customers outside Iceland continued to grow in 2006 and accounted for 61% of total lending at the end of the year. The banks' equity ratio rose year-on-year to 15% from 12.5%, the highest level since capital adequacy ratios were introduced.

Surge in foreign lending and deposits

Lending by deposit money banks (DMBs) continued to soar in 2006. Their domestic lending increased by 41% over the year and foreign lending by even more, 63%. Deposits by non-residents in domestic banks – including their overseas branches – grew sixfold, compared with 20% growth for deposits by residents. In spite of this massive increase, deposits remained broadly unchanged as a proportion of total DMB liabilities year-on-year.⁴ Securities issuance continued to account for the bulk of DMB funding, most of it in foreign markets and denominated in foreign currency. Foreign subordinated loans grew by a brisk 139% over the year, which partly explains the banks' higher CAD ratios.

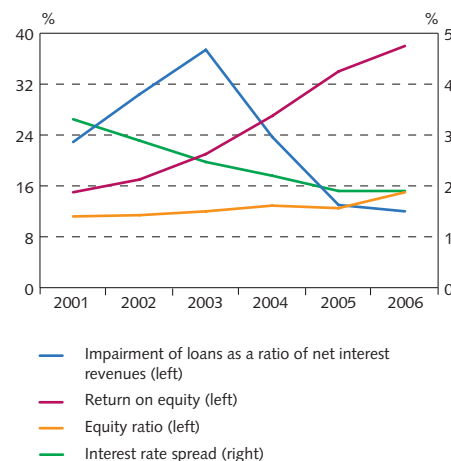
Outstanding credit at other credit institutions increased by just over 29% in 2006.⁵ Lending by the Housing Financing Fund (HFF), which accounted for 55% of total outstanding lending by other credit institutions at the end of 2006, rose by 9% over the year. Securities issues by other credit institutions grew by 11% during the year, the bulk in the form of HFF bonds.

3. Discussed further in Chapter IV.

4. Excluding capital stock and subordinated debt.

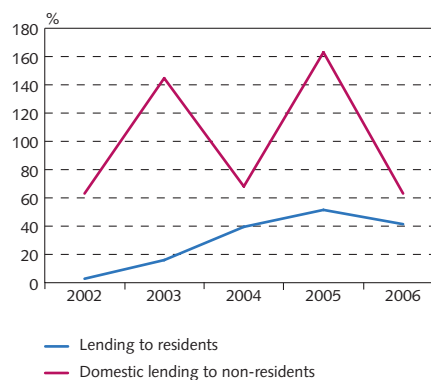
5. Other credit institutions comprise the Housing Financing Fund, investment banks, leasing companies, payment card companies and investment credit funds.

Chart III-1
Largest commercial banks¹



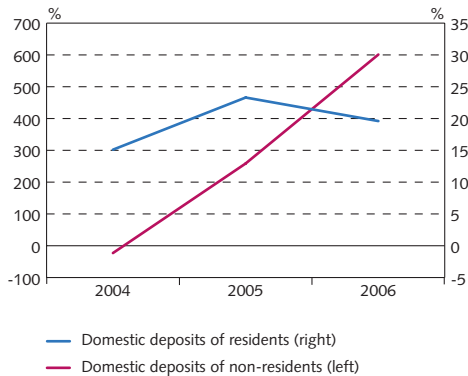
1. Glitnir, Kaupthing Bank and Landsbanki. Consolidated figures.
Sources: Banks' annual reports, Central Bank of Iceland.

Chart III-2
DMB lending¹
12-month movements



1. Parent companies.
Source: Central Bank of Iceland.

Chart III-3
DMB deposits¹
12-month movements



1. Parent companies.
Source: Central Bank of Iceland.

Depositors' and Investors' Guarantee Fund

The Depositors' and Investors' Guarantee Fund operates in two divisions as provided for by Act No. 98/1999, on Guarantees for Depositors and Investors, Regulation No. 120/2000 on the same subject and the articles of association approved at its founding meeting on December 28, 1999. By law, the total assets of the Fund's deposit division shall amount to a minimum of 1% of the average amount of guaranteed deposits in commercial banks and savings banks during the preceding year. Guaranteed deposits have grown rapidly in recent years, with a corresponding increase in required collections. So far, the Fund has not needed to draw on its assets on account of difficulties faced by member companies in meeting their obligations. By law, total minimum assets of the Fund's securities division shall be 100 m.kr. One of the fund's members, Burnham International in Iceland, is still in receivership. The securities division of the Depositors' and Investors' Guarantee Fund is likely to incur some outlays relating to its insolvency. This has been taken into consideration in calculation of the securities' division's capital stock.

Payment and settlement systems

Two types of payment system are in operation in Iceland, both of them settlement systems, i.e. the Central Bank's real-time gross settlement (RTGS) system and the netting system operated by Fjölgreiðslumiðlun hf. (FGM). Settlements of securities transactions are processed by the RTGS system. Participants are the commercial banks, savings banks and Central Bank. The Icelandic Banks' Data Centre (RB) provides software services for all the systems and the Central Bank acts as a settlement provider.

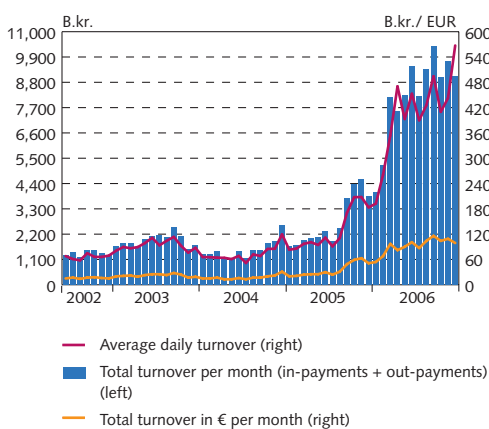
RTGS system

The Central Bank operates the RTGS system. It handles final settlement of individual payment orders of 10 m.kr. or above and is open from 9 a.m. to 5 p.m. on business days of banks.

Turnover in the system has increased substantially. Chart III-4 shows monthly turnover in the RTGS system from 2002 to the end of 2006 (both deposits and withdrawals). Monthly turnover grew from 3,800 b.kr. in December 2005 to 9,076 b.kr. in December 2006. Daily average turnover per month increased correspondingly from just under 200 b.kr. to 567 b.kr. over the same period. Over 2006 as a whole, average monthly turnover was 8,203 b.kr. and average daily turnover 404 b.kr., more than triple the figure of 128.7 b.kr. per day the previous year.

User fees in the RTGS system were reviewed at the end of 2006 and a new tariff entered into force at the beginning of 2007. Alongside an increase in the fixed annual fee and fees for individual transactions, access and connection charges were introduced for new users. The RTGS system is subject to the provisions of Central Bank Rules No. 788/2003, which were under review at the end of the year.

Chart III-4
RTGS system turnover
June 2002 - December 2006



Source: Central Bank of Iceland

Structure and organisation of payment systems

The Central Bank's Annual Report for 2005 summarised the main findings of a report by Swedish consultants on the RTGS system. Work began that year on reforms to the system in line with the consultants' recommendations, addressing external factors in particular. Reforms continued in 2006, shifting the focus to internal factors highlighted in the Swedish report. The Board of Governors decided in 2006 to draw an even sharper line between the Central Bank's different payment system functions and divide them into two main units as of 2007.

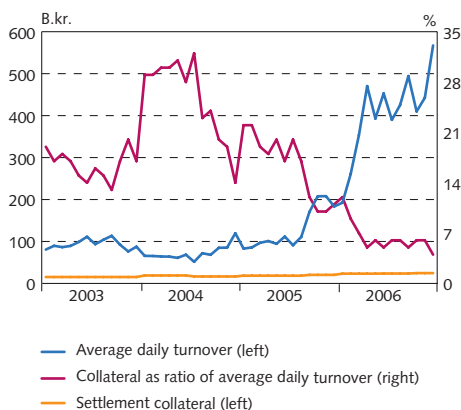
Day-to-day operation of the RTGS system was separated from the Bank's oversight function. A dedicated Payment Systems Unit was established within the Financial Stability Department with a remit including systemic oversight of the RTGS system and other systemically important payment systems under third-party ownership. Another function of the unit is to ensure that all domestic systemically important systems comply with the relevant local and international regulatory frameworks. Given the pace of advances in payment structures, it is important for the Central Bank to be fully equipped to adapt and evolve its payment systems to match the rapidly changing financial market environment. It was decided to evaluate how well the current RTGS system meets market requirements and performs in comparison with other countries' systems, and to reorganise the collection, storage and processing of payment system data.

Day-to-day operation of the RTGS system will be assigned to the Interbank Settlement Unit of the Central Bank's Accounting Department. Besides operation and monitoring of the RTGS system, this entails a role in settlements made through it by other payment systems, i.e. the netting system and Icelandic Securities Depository (ISD) securities settlement system. Interbank settlement is also responsible for collecting data on RTGS system operation and documenting its efficiency and such operational problems as may arise. The cost of operating the RTGS system will be calculated separately to give the Central Bank a basis for setting the fees that credit institutions pay for participation in payment settlements.

Netting system

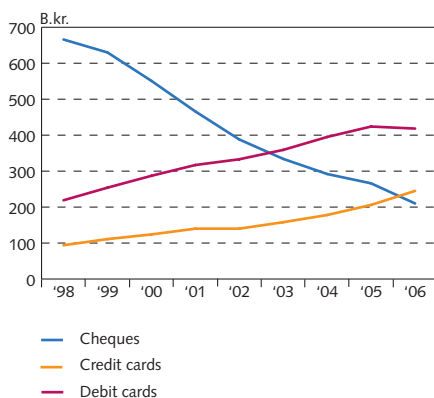
The Central Bank has taken part in development of the FGM netting system ever since its establishment. Separation of the RTGS and netting systems has been ongoing and FGM has assumed increasing responsibility for netting system operation over the years. In 2006, FGM formally acquired access and user rights for the netting system. User fees were reviewed in mid-2006. Agreements on system operation were also renewed and new agreements made between participants and FGM as the system owner and operator. Furthermore, preparations began for the introduction of automatic locks in the netting system which will be activated in 2007. Settlement of participants' netted positions has been made at 5 p.m. on banking days since the system began operation, but towards the end of 2006 it was decided to add a morning settlement at 8:30 a.m. on banking days. Plans have been drawn up to enhance collection and processing of data from the netting system. The netting system is subject to the

Chart III-5
Average daily turnover in the RTGS system
and settlement collateral
January 2003 - December 2006



Source: Central Bank of Iceland.

Chart III-6
Turnover: Payment cards and Cheques



Source: Central Bank of Iceland.

provisions of Central Bank Rules No. 789/2003, which were under review at the end of the year. Technical locks were also introduced in 2006 to prevent payments over 10 m.kr. from being split and then sent through the netting system after the RTGS system has closed, which is unauthorised under current rules.

Securities settlement system

The Icelandic securities settlement system is operated on the basis of a cooperation agreement between the Central Bank, ISD and Iceland Stock Exchange (ICEX). It includes all institutional arrangements for confirmation, determination of rights and obligations, clearance and settlement of securities trades and safekeeping of securities. A T+1 settlement cycle is used whereby trades are settled at 8 a.m. the following day, before the RTGS System opens for daily business. Preparations were launched in 2006 to bring the settlement cycle into line with the T+3 norm in neighbouring countries, i.e. shares are settled and delivered three days after being bought or sold. The new arrangement is expected to take effect in 2007.

Settlement collateral

Adequate collateral for payment system settlement is vital for ensuring the sound and efficient operation of the financial system in the event that a credit institution cannot honour its settlement obligations. At the beginning of 2006, collateral of all credit institutions amounted to 23.3 b.kr. in the RTGS system and 5.9 b.kr. in the FGM netting system, a total of 29.2 b.kr. Collateral amounts were revised during the year and totalled 30.5 b.kr. at the end of 2006. RTGS system collateral was set at 24.6 b.kr. but netting system collateral was left unchanged during the year.

Collateral security amounts in the RTGS system are set so as to meet in full the single highest amount that credit institutions agree between themselves at any time. In the netting system, the Central Bank records the highest daily settlement exposure for each credit institution as a basis for estimating the collateral requirement. Technical locks on the RTGS system automatically reject all payment orders which would entail an uncollateralised overdraft.

Payment instruments

Cash in circulation

At the end of 2006, notes and coin in circulation outside the Central Bank amounted to 14.5 b.kr., an increase of 1.3 b.kr. from 2005. This increase, equivalent to almost 10%, is noteworthy given the growing use of other payment instruments. At the end of May 2006, the Central Bank announced that banknotes with a denomination of 10, 50 and 100 krónur would be withdrawn from circulation. The deadline for redemption of withdrawn notes is 12 months from the publication of the announcement. Over this period, all commercial banks and savings banks are obliged to accept them in exchange for other legal Icelandic tender. After the deadline the notes will cease to be valid in business transactions, but the Central Bank of Iceland will redeem them for at least 12 months after the deadline. At the end of 2006,

the value of outstanding 10, 50 and 100 krónur banknotes amounted to 118 m.kr.

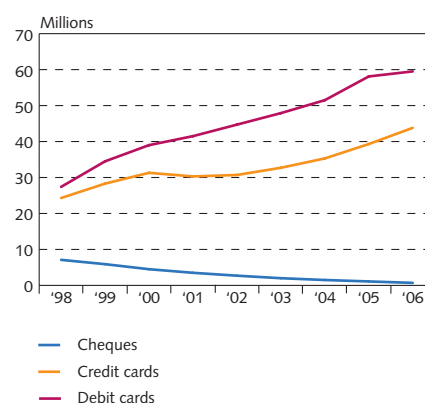
The Central Bank gives high priority to maintaining the credibility of Icelandic banknotes, among other things with security features in notes and by regular processing of them. Note processing includes counting, identification of forgeries and sorting of notes into fit and unfit. Fit notes are recirculated and unfit destroyed. The note processing department received 13.3 million notes from commercial banks and savings banks in 2006, and 4.9 million notes were destroyed.

Payment card turnover still on the increase

Credit and debit card turnover is still growing year-on-year and cheque turnover decreasing. Credit card turnover increased by 48 b.kr. (24%) in 2006, to 245 b.kr. The increase was divided between 38 b.kr. in domestic transactions and just under 10 b.kr. outside Iceland. Debit card transaction volume declined by 1.4% in 2006, from 424 b.kr. to 418 b.kr. Cheque transaction volume was down by almost 21% year-on-year, to 210 b.kr. at the end of 2006.

The number of domestic transactions with debit cards increased marginally year-on-year and with credit cards by 11.6%. The number of cheque transactions fell by 32%.

Chart III-7
Number of transactions



Source: Central Bank of Iceland.

IV Various Central Bank activities

Foreign reserves

The Act on the Central Bank of Iceland stipulates that one of its functions is to maintain Iceland's foreign reserves. Accordingly, the Board of Governors lays down rules on management of the reserves, which are approved by the Supervisory Board. Foreign reserves comprise the Central Bank's holdings of foreign securities, deposits in foreign banks and money market funds, gold, Special Drawing Rights (SDRs) and the reserve position at the IMF. SDRs refer to the Bank's position in its SDR account at the IMF.

The Board of Governors sets rules for investment of the reserves. Funds may be deposited in international financial institutions and invested in money market funds and listed securities issued by entities in member countries of the OECD. Issuers can be sovereigns, local governments, state enterprises, international organisations and financial institutions. A minimum rating of A+/A1/A1 from recognised ratings agencies (Moody's/S&P/Fitch) is required for long-term securities. Short-term securities require minimum ratings of A-1/P-1/F-1, respectively, from the same agencies. The same demands are made towards deposit-taking institutions. Under the rules set by the Board of Governors, the bulk of the reserves are invested in securities with a lifetime of more than one year, but a share of the reserves must be held in sight accounts. The average duration of securities and deposits in the foreign reserves should not exceed five years. The Bank's gold reserves amounted to just over 64 thousand ounces at end-2006. The gold is held in the Bank of England and may be lent against gold or dollar interest rates.

The Central Bank has made agreements for short-term credit facilities (secondary reserves) with foreign banks, in order to strengthen its foreign reserves when necessary. Committed credit facilities were available at the end of 2006 for the equivalent of 19 b.kr.

In 2006, the Bank's foreign reserves strengthened by 100.5 b.kr. to reach 167.8 b.kr. at the end of the year. Together with available credit facilities, primary and secondary reserves therefore totalled 187 b.kr. Most of the expansion in foreign reserves is explained by the government's specific measure to boost the Central Bank's external position by borrowing €1 billion in international markets which was deposited in the Central Bank and added to the reserve.¹ In addition, the Central Bank has non-committed access to credit lines with a number of international financial institutions.

The Central Bank's net foreign balance is its foreign-denominated assets net of foreign-denominated liabilities. Currency composition of the net foreign balance is adjusted with the aim of minimising risk. Currency composition of the Central Bank's foreign reserves is

1. The bond issue is described in the section on Treasury foreign borrowing on p. 21.

Table IV-1. Returns on investment of Central Bank foreign reserves

<i>US dollar</i>	2002	2003	2004	2005	2006
Interest income (%)	5.07%	3.89%	3.74%	3.84%	4.06%
Price gain/loss (%)	5.60%	-0.62%	-1.99%	-2.35%	0.01%
Total return on securities (%)	10.67%	3.27%	1.75%	1.49%	4.07%
Average maturity at year-end	2.96	2.88	2.64	2.33	2.09
MSCI 1-3-year index	5.88%	1.90%	0.91%	1.66%	3.95%
Average maturity at year-end	1.62	1.80	1.65	1.69	1.70
MSCI 3-5-year index	11.35%	2.50%	2.12%	0.86%	3.50%
Average maturity at year-end	3.58	3.80	3.66	3.52	3.52
Time deposits	1.65%	1.07%	1.37%	3.16%	4.93%
LIBOR (annual average)	1.75%	1.20%	1.48%	3.30%	4.98%
<i>Euro</i>	2002	2003	2004	2005	2006
Interest income (%)	4.80%	3.95%	3.59%	3.33%	3.67%
Price gain/loss (%)	2.80%	-0.19%	1.75%	-0.46%	-2.55%
Total return on securities (%)	7.60%	3.76%	5.34%	2.87%	1.12%
Average maturity at year-end	2.76	3.26	3.31	2.8	3.52
MSCI 1-3-year index	5.67%	3.19%	3.21%	2.16%	1.80%
Average maturity at year-end	1.73	1.63	1.61	1.73	1.81
MSCI 3-5-year index	8.29%	3.68%	5.62%	2.91%	0.62%
Average maturity at year-end	3.35	3.42	3.47	3.5	3.56
Time deposits	3.24%	2.35%	2.02%	2.08%	2.82%
LIBOR (annual average)	3.31%	2.36%	2.07%	2.12%	2.83%
<i>Sterling</i>	2002	2003	2004	2005	2006
Interest income (%)	6.29%	5.76%	5.58%	5.50%	5.01%
Price gain/loss (%)	1.25%	-1.79%	0.09%	0.15%	-2.86%
Total return on securities (%)	7.54%	3.97%	5.67%	5.65%	2.15%
Average maturity at year-end	2.19	2.78	3.31	2.95	2.22
MSCI 1-3-year index	6.70%	3.35%	4.66%	4.90%	3.07%
Average maturity at year-end	2.00	1.10	2.05	1.51	1.79
MSCI 3-5-year index	8.74%	2.83%	5.15%	5.62%	1.48%
Average maturity at year-end	3.69	3.47	3.53	3.36	3.38
Time deposits	3.77%	3.52%	4.31%	4.66%	4.70%
LIBOR (annual average)	3.91%	3.63%	4.42%	4.71%	4.65%

regularly reviewed and confirmed in the Board of Governors' working rules. The weight of currencies is determined by using a model that minimises volatility in the foreign value of the reserves. Foreign reserves are comprised of the four most important currencies in Iceland's external trade: the US dollar (accounting for 35% in 2006), euro (45%), pound sterling (15%) and yen (5%).

Currency-by-currency investment of the foreign reserve

Table IV-1 shows the returns on investment of individual currencies comprising the foreign reserves over the past five years. The MSCI Sovereign Bond Index is used as a benchmark in measuring investment performance for bonds with a maturity of 1-3 years and 3-5 years, respectively. The average duration of the Central Bank's portfolios lies between these indices. Returns on short-term investments are compared with LIBOR rates in the respective currency; deposits are generally very short-term investments. The benchmark for returns on short-term investments is 12.5 basis points below LIBOR (LIBID).

Treasury foreign borrowing

By an agreement with the Minister of Finance, the Central Bank is assigned the implementation of Treasury foreign borrowing and other specific tasks as authorised under Act No. 43/1990 on the National Debt Management Agency. Under this agreement, the Central Bank implements the Minister of Finance's decisions on foreign borrowing, interest rate swaps and currency swaps outside Iceland and management of short-term borrowing facilities, along with management of other foreign loans of the Treasury. The agreement also assigns to the Central Bank a consultative role on borrowing and debt management policies, and relations with international ratings agencies. Furthermore, the Bank supervises the credit terms of entities enjoying Treasury guarantees which intend to borrow in the international market. The Bank oversees the Treasury's foreign loan accounts and provides related services. In managing the Treasury's foreign borrowing, the Central Bank aims to secure the reputation of the Republic of Iceland in international markets and procure foreign credit on the best available terms.

Foreign borrowing

Long-term credit is procured with issues under a European Medium-Term Note (EMTN) Programme. Short-term credit is issued through two commercial paper programmes: a Euro-Commercial Paper (ECP) Programme and a United States Commercial Paper (USCP) Programme. The Treasury also has a multi-currency revolving credit facility.

EMTN Programme

The EMTN programme was first signed in 2001. It was most recently renewed in 2006 and the ceiling now amounts to 2 billion US dollars. The agreement ensures access for the Treasury to credit in various currencies and also offers greater flexibility in issuance.

Borrowing in the euro market

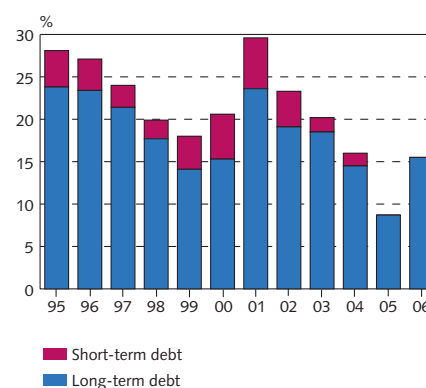
Four liabilities came to maturity in 2006. Total amortisation of long-term debt during the year amounted to 22.7 b.kr. Towards the end of 2006, the Treasury made its largest ever issuance, amounting to €1 billion under the EMTN Programme. With a maturity of five years, it was made to strengthen the Central Bank's foreign reserves. Re-offer spread was 1 point below EURIBOR.

Table IV-2. Foreign long-term bonds and Treasury bonds maturing or prepaid in 2006

	Amount (millions)		Date of issue	Maturity	Date paid
	Currency	Kr.			
<i>Liabilities maturing</i>					
Loan ¹	0.097 USD	6	27.6.1994	14.2.2006	14.2.2006
Loan	3.6 USD	253	10.5.1999	10.5.2006	10.5.2006
Loan	250 EUR	22,390	6.4.2001	6.4.2006	6.4.2006
Loan	1.2 EUR	108	10.5.1999	10.5.2006	10.5.2006
Total:		22,756			

1. Loan taken by the Tourism Fund on 27.6.1994. With a principal of 2.1 million USD, this was a serial loan paid twice a year. The final instalment, paid on 14.2.2006, amounted to \$97,507.

Chart IV-1
Treasury foreign debt
As % of GDP at end of year



ECP issues used to retire Treasury debt

ECP issues were used to retire Treasury long-term foreign debt in the first half of 2006. In the second half of the year, the outstanding stock of Treasury commercial paper was paid up in full. The Central Bank made regular currency purchases in the domestic interbank market for this purpose throughout the year. No ECP or USCP issues were therefore outstanding at the end of 2006. The Republic of Iceland's ECP programme was established in 1985 and the current agreement is from 1995. The maximum outstanding balance is 500 million US dollars with a multi-currency option allowing for issuance in other major currencies. Euro-Commercial Paper was issued with an average spread of 10 basis points below LIBOR. There were three dealers on the programme: Citibank International, SEB and Deutsche Bank. The USCP Programme established in 2001 is linked with the Euro-Commercial Paper Programme whereby the total amount in the two issues may not exceed 1 billion US dollars. Dealers are Citibank and J.P. Morgan of New York. No issuance was made in the US market in 2006. Total issuance under the ECP programme amounted to 100.5 million US dollars and €73.5 million or the equivalent of 13.7 b.kr. in all. The average maturity of paper issued in 2006 was 84 days.

Debt management and risk analysis

The Central Bank's strategy for Treasury foreign debt management aims to spread debt service as evenly as possible over coming years as well as to optimise its composition with particular regard to interest rates, maturity and currency denomination. In recent years prepayment options have been exercised in order to refinance debt on more favourable terms. Measures in 2006 to strengthen the Central Bank's foreign reserves, described above, represent some departure from this principle. Total Treasury foreign debt at the end of 2006 amounted to 176 b.kr., an increase of 90 b.kr. from the end of the previous year due both to foreign borrowing to boost the reserves and to the depreciation of the króna. However, the Treasury's net external position remains unchanged. At the end of 2006, the weighted average maturity of foreign long-term borrowing was 4.49 years and the average duration 3.8 years.

Sovereign credit rating of the Republic of Iceland

Rating agencies are an important determinant of credit terms in global financial markets. The best known rating agencies are Moody's Investors Service and Standard & Poor's from the US and Fitch Ratings of Europe. Ratings help to provide an indication of the terms that a

Table IV-3. Sovereign credit ratings at end of 2006

	Foreign currency			Domestic currency			Most recent
	Long-term	Short-term	Outlook	Long-term	Short-term	Outlook	
Fitch	AA-	F1+	Negative	AAA		Negative	November 2006
S&P	A+	A-1	Stable	AA	A-1+	Stable	December 2006
Moody's	Aaa	P-1	Stable	Aaa	P-1	Stable	December 2006

borrower will enjoy. The Republic of Iceland enjoys confidence as a borrower in international markets and all main markets are open to the Treasury because of its strong ratings.

Moody's rating is now Aaa for long-term foreign and domestic obligations, Aaa for country ceiling and P-1 for short-term obligations, which are the highest ratings that the agency issues. In its analysis on Iceland in August 2006, Moody's says the "Aaa rating and stable outlook are supported by institutional strength, low government debt and a tested ability to withstand shocks [...] Despite these positive features, a number of macroeconomic imbalances have developed, including a fast-growing and high level of foreign currency debt, particularly by the banking system." However, Moody's considers that Iceland's financial system is "well-managed, well-capitalized and adequately liquid."

Fitch assigns a rating of AA- for foreign long-term obligations and F1+ for short-term obligations. Its rating of AAA for domestic long-term obligations is the highest that the agency gives. The country ceiling is AA. In February 2006, Fitch revised Iceland's outlook to negative from stable, "triggered by a material deterioration in Iceland's macroprudential risk indicators, accompanied by an unsustainable current account deficit and soaring net external indebtedness." According to Fitch, the ratings are underpinned by strong public finances and a wave of structural reforms since the 1990s. In its annual report on Iceland in November 2006, the ratings were affirmed.

In December 2006, Standard & Poor's lowered its foreign currency sovereign credit ratings to A+ long-term and A-1 short-term, from AA- and A-1+ respectively. At the same time, the long-term local currency rating was lowered to AA from AA+ and the short-term local currency rating was affirmed at A-1+. The outlook is stable. Standard & Poor's stated that "the downgrade reflects the loosening of fiscal policy by the Icelandic government ahead of the 2007 election [...] and an increasingly unbalanced policy mix. However, "the ratings on Iceland remain supported by its stable and flexible political institutions, high level of prosperity, and strong long-term economic growth prospects and low and declining government debt level."

Internal rules on the preparation, rationale and presentation of monetary policy decisions

Article 24 of the Central Bank Act No. 36/2001 states that "the Board of Governors lays down internal rules to be approved by the Supervisory Board on the preparation of, arguments for and presentation of its monetary policy decisions." These rules have been applied since they were formally set in the beginning of 2002. The main principles on which the rules are based concern utilisation of information and expertise, professionalism, transparency and the documentation of arguments behind monetary policy decisions. Their provisions cover the production of inflation forecasts, procedures for evaluating economic and monetary developments and outlook and appraising monetary policy, and the Board of Governors' decision-making process and the announcement of such decisions. The rules were reviewed in 2006 and are published on the Central Bank website.



Financial stability functions

The Central Bank's financial stability functions were defined more closely with a decision by the Board of Governors in 2006. With reference to the legal foundation on which the Central Bank's operations are based, it explains the main underlying principles. The decision specifies how the Central Bank of Iceland performs these functions with respect to framework and oversight, collection and communication of data, research, analysis and communication, cooperation and contingencies. It also makes provision for cooperation and division of tasks between Bank departments on financial stability and arrangements for regular in-house Financial Stability meetings. The decision is published on the Central Bank website.

Publications and information

Strict requirements are made of central banks to explain clearly their monetary policy objectives and implementation and other activities. In Iceland, the Central Bank is obliged by law to publish reports on its monetary policy, its monetary, exchange rate and foreign exchange developments, and its measures in these areas. The forum it uses is *Peningamál*, which is published simultaneously in English translation as *Monetary Bulletin*. This publication also presents research findings by Bank employees connected with monetary policy, financial stability and the Bank's general activities. Three editions of *Monetary Bulletin* were published in 2006.

The second separate edition of the Central Bank's *Financial Stability* report was published during the year, discussing the position and strength of the Icelandic financial system and financial stability in a macroeconomic context. *Financial Stability* is published once a year.

In its Annual Report, the Bank outlines various aspects of its operations. The Chairman of the Board of Governors gives an account of the Bank's policy at its annual meeting. Eleven editions of *Hagvísar/Economic Indicators* are published a year along with regular statistical data in Icelandic and English on the Statistics pages of the Central Bank's website.

Another regular publication (in Icelandic) has been *Fjármálatíðindi*, a platform for academic articles on economics. A series in English, *Central Bank of Iceland Working Papers*, publishes economic research conducted within the Bank and outside it. The annual *Economy of Iceland* has been published for many years and contains information on the Icelandic system of government and economic structure and developments. Central Bank publications in 2006 are listed in the appendix to the present Annual Report. The Central Bank publishes regular announcements of decisions by the Board of Governors and various other aspects of its activities. Other news is posted on the Bank's website without an official press release being issued.

Electronic versions of the Bank's publications are available on its website. Press releases, news, statistics and various information on the Bank's activities are also published on the website in Icelandic and English. The Bank also makes a point of promoting its activities to the public, among other things by arranging visits by students and other groups.

Research

A wide range of research is conducted within the Central Bank in connection with its functions. Most is centred in the Economics Department but other departments are active in research as well and, on occasion, the Central Bank commissions or backs outside research.

To pursue a forward-looking monetary policy, a central bank needs models for assessing the economic outlook, especially inflation. A considerable share of research at the Central Bank of Iceland is devoted to this task. A quarterly macroeconomic model (QMM), which has been under design for some years, was introduced in the beginning of 2006 and has substantially enhanced the Bank's forecasting and analysis. Development of the model will continue and analysis of its long-term properties is well advanced. Preparation also began for the development of a new DSGE model, which is more suitable for economic policy simulations and will be used alongside QMM.

Projects completed in 2006 included a study of the impact of structural changes on the Icelandic housing market, development of an indicator model for the domestic business cycle, a study of the supply side of small new Keynesian DSGE models and design of new currency baskets for the Icelandic króna. Among research projects in progress at the end of the year were estimations of a Bayesian forecasting model for inflation in Iceland, the yield curve for domestic interest rates, a simple forecasting system for demand and inflation, and a VAR model for high-frequency indicators. A research project was also launched into specific monetary policy tasks in very small open economies with an independent floating currency. Furthermore, a number of smaller research projects are ongoing, including design of short-term forecasting models for key subcomponents of the CPI, an estimation of the impact of foreign labour on the Icelandic economy, a study of automatic fiscal stabilisers, design of indicators for the housing market and residential investment, and studies of the correlation between income and consumption, of the origin, composition and funding of the current account deficit, and of the informational value of preliminary national accounts estimates. Various long-term projects are also in progress, several in cooperation with academics in Iceland and abroad. These include design of methodologies for estimating the output gap and studies of domestic real interest rates and changes in the pass-through from the exchange rate of the króna to inflation.

Research continued in 2006 at the Financial Stability Department, addressing the development of comprehensive stress testing for financial institutions. The results were published in *Financial Stability* during the year.

In order to create a framework for the Bank's research activities and communicate its findings to professionals and the general public alike, regular presentations are organised at which researchers inside and outside the Bank report their findings and discuss them with other Bank employees and researchers. Central Bank staff presented their research findings at seminars outside the Central Bank as well, both in Iceland and abroad. They also attended local and international conferences to present their own findings and hear those of other researchers, and lectured at public, specialist and academic venues.





The Central Bank underlines the importance of publishing research by its experts in internationally recognised academic journals and a number of papers were published during the year.

Data collection

The Central Bank collects information on a regular basis about the domestic credit market, balance of payments and external position of the economy. Most institutions and companies operating in the domestic credit market report monthly on balance sheet items. They are obliged to provide the Central Bank with information about interest rate changes immediately. The balance of payments and external position are prepared on a quarterly basis. These data form the basis for the Bank's assessment of important aspects of monetary developments as well as for regular dissemination of statistical information both in the Bank's publications and on the Statistics pages of its website. The Statistics pages provide links to relevant resources and are published simultaneously in English.

In cooperation with the Ministry of Finance, the Central Bank operates a FAME time-series database management system which houses a range of databases with hundreds of thousands of time series, including data from corporate accounts with restricted access. Similar systems are used by most of the largest central banks and many international institutions. The Central Bank of Iceland has subscribed to the IMF's Special Data Dissemination Standard (SDDS) since 1996 and publishes an advance release calendar on its website in accordance with the standard.

Cooperation with the Financial Supervisory Authority

Legislation on the Central Bank and Official Supervision of Financial Activities states that the Central Bank and Financial Supervisory Authority (FME) shall conclude a special agreement further stipulating the cooperation between them. An agreement on cooperation was first made in 1999 and most recently renewed in 2006. The agreement is published on the websites of both institutions. The Central Bank Act states that the Bank shall grant the FME all the information which it holds and may be utilised for the latter's activities. These institutions regularly exchange statistics and other information and the Board of Governors of the Central Bank and the Director of the FME hold regular consultative meetings. The Central Bank and FME have conducted joint contingency exercises, the first in 2004 and another early in 2006, as described in the following and on p. 12.

Joint Central Bank and FME contingency exercises

Contingency plans and exercises are a normal part of Central Bank and FME activities. Such exercises imply nothing about whether a request for government support would be more or less likely to be accepted. However, the exercises do leave both institutions better equipped to make a careful, coordinated response in such an event, and to shorten the decision-making process. This should reduce the risk of mistakes.

A joint contingency exercise was held in January 2006, along similar lines to the first exercise in January 2004. Aimed at the financial

markets, it tested communications within and between the Central Bank and FME. It was based on a scenario of shocks to the operations and environment of the banks, an insurance company, pension funds, etc., resulting in problems in liquidity, capital adequacy, payment systems and other communication shocks. After the exercise the events were reviewed and a report was produced identifying scope for improvement.

MoU by government authorities on financial stability and contingencies

In order to respond swiftly to unexpected conditions in the Icelandic financial system, and to bring Iceland's financial markets and economy into line with best international practice, the government authorities need contingency plans. Plans need to be drawn up in case of serious difficulties in the financial markets caused either by failures in the domestic financial market or by changes in external conditions. At the beginning of 2004, the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, FME and Central Bank of Iceland established a joint task force to consider further elaboration of the authorities' contingencies in this respect. Formal consultation between the Central Bank, the FME and ministries on contingency plans for financial market shocks was established in February 2006. The MoU signed between them on February 21² was one of the task force's proposals.

Treasury debt management functions

Under an agreement with the Minister of Finance, the Central Bank provides specific services to the Treasury, such as foreign borrowing and services connected with domestic borrowing. It assigns the Central Bank functions including the management of Treasury foreign borrowing, overseeing of foreign borrowing by parties enjoying Treasury guarantees, accounting of specific foreign loans taken by the Treasury, and supervision of debt service. Central Bank tasks connected with Treasury domestic borrowing are largely a thing of the past, although the agreement states that the Bank shall redeem the Treasury's marketable securities in accordance with their terms. It also stipulates that the Ministry of Finance, Central Bank and National Debt Management Agency shall operate a consultative committee whose chief purpose is to serve as a forum for exchanging views about the financial market position and outlook, and about current and planned domestic and international borrowing by the Treasury.

Agreement with the Ministry of Finance on current accounts and interest rates

The Central Bank Act which was approved by Parliament in May 2001 removed Treasury access to credit with the Central Bank. Under an agreement between the Ministry of Finance and the Central Bank on

2. Memorandum of Understanding between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, Financial Supervisory Authority and Central Bank of Iceland, on consultation concerning financial stability and contingency plans, February 2006, <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=3668>.



current accounts and interest rates, which was renewed most recently in 2005, the rate of interest paid on average deposits is the same for the Treasury's current accounts and those held by credit institutions, as of the beginning of 2006.

International cooperation

The Central Bank of Iceland has extensive responsibilities and obligations in the field of international finance. The Bank cooperates closely with other central banks and international economic and monetary organisations.

Nordic central banks' MoU on financial crisis management

At a meeting in Stykkishólmur, Iceland, in June 2003, the Governors of the central banks of Denmark, Finland, Iceland, Norway and Sweden signed a Memorandum of Understanding (MoU) on financial crisis management. The MoU has been published in its entirety on the websites of all the signatory banks. Nordic central banks cooperate closely on financial stability tasks and contingencies for meeting challenges to the financial system, especially illiquidity.

The International Monetary Fund (IMF)

The Central Bank represents Iceland at the International Monetary Fund. Davíð Oddsson, Chairman of the Board of Governors of the Central Bank, represented Iceland on the IMF Board of Governors. Bolli Þór Bollason, Secretary General at the Office of the Prime Minister, was Iceland's alternate on the IMF Board. Iceland cooperates with the Nordic and Baltic countries through a Constituency at the IMF and they jointly elect an Executive Director as one of the Fund's 24 Executive Board members. Finland's Minister of Finance, Eero Heinaluoma, represented the Nordic and Baltic countries in 2006 on the Fund's International Monetary and Financial Committee (IMFC), which acts in a consultative capacity to the IMF Board of Governors. Martti Hetemäki, Permanent Under-Secretary of State in the Finnish Ministry for Finance, was chairman of the Nordic-Baltic Monetary and Financial Committee (NBMFC), whose role is to coordinate and manage cooperation within the Constituency. Anders Svor, Assistant Director of the International Department of Norges Bank, the Central Bank of Norway, was the chair of the NBMFC Alternates, which addresses various common Constituency issues and reports to the NBMFC, in 2006.

The constituency's permanent representative on the IMF Executive Board in Washington during the year was Tuomas Saarenheimo from Finland and his alternate was Jón Sigurgeirsson from Iceland.

The spring meeting of the International Monetary and Financial Committee was held in Washington and the autumn meeting in Singapore. Once every three years, the autumn meeting is hosted outside the United States, where the IMF is headquartered. In connection with these events, the Central Bank of Iceland published on its website the Nordic and Baltic Constituency Office's reports to the IMF on the main activities of the Fund and its Executive Board. Nordic-Baltic speeches that were presented to the IMFC and the IMF Annual Meeting were also published.

An IMF staff mission visited Iceland in May 2006 and its concluding statement was published on the Central Bank of Iceland website. After being discussed in the Executive Board of the IMF, the Staff Report for the Article IV Consultation was published on the IMF and Central Bank websites in August 2006.

The Bank for International Settlements (BIS)

The Central Bank is a shareholder in the Bank for International Settlements (BIS) in Basel. BIS is an important forum for consultation among central banks as well as being an information and research centre in economics, especially in the monetary field. BIS also addresses financial stability, surveillance of financial institutions and their soundness. Central Bank representatives participate in a number of BIS meetings.

Other central banks

Extensive cooperation takes place among the Nordic central banks in a number of areas. The governors of the Nordic central banks hold an annual meeting to discuss monetary issues, financial stability and other relevant topics of joint interest. Their experts in various areas cooperate and share information on issues including reserve management, market operations, legal matters, economic research, general monetary matters, financial stability, administration, human resources, communication of information, etc. The Central Bank of Iceland also cooperates with various other central banks, including the European Central Bank. The Chairman of the Board of Governors meets regularly with the President of the ECB. Other Central Bank representatives have met ECB experts to discuss aspects of monetary policy formulation and implementation and payment systems.

The Organisation for Economic Cooperation and Development (OECD)

Central Bank representatives participate on a regular basis in the work of various OECD committees and groups, including the Economic Policy Committee, Working Party 1, the Committee on Financial Markets and an expert committee on government debt management. OECD experts visit Iceland regularly for discussions with the authorities on economic developments. Similar discussions are held with all the member countries. Following the visits, the OECD publishes its assessment of economic conditions. An OECD mission visited Iceland in the first half of 2006 and subsequently published its Country Survey in August.

Other financial institutions and rating agencies

In connection with the management of international reserves, the Treasury's foreign borrowing and other tasks, the Central Bank is engaged in business relations with a number of financial institutions. It also handles regular communication with international credit rating agencies.

Central Bank participation on the boards of institutions and companies

The Central Bank has an equity interest in the Banks' Data Centre (RB) and according to a collaboration agreement on it from 1994 originally contributed one-fifth of its initial capital. Representatives from the Bank serve on the RB Board, auditing committee and consultative committee.

At the beginning of 2006, the Central Bank held an 11% equity interest in Eignarhaldsfélag Verðbréfaþings hf., which owned Kauphöll Íslands hf. (Iceland Stock Exchange) and Verðbréfaskráning Íslands hf. (The Central Securities Depository), and had one member on its board. As stated in the notes to the financial statements, OMX acquired Eignarhaldsfélag Verðbréfaþings in 2006. The Central Bank has not had a representative on the board since that time.

The Financial Supervisory Authority is governed by a three-person board appointed by the Minister of Commerce. One member is nominated by the Central Bank from its own staff.

The Central Bank has an 8% equity interest in the Fjölgreiðslumiðlun (FGM) netting service provider and appoints one member to its board.

The Depositors' and Investors' Guarantee Fund is managed by an employee of the Central Bank.

Employees of the Central Bank are members of the Bank Employees' Pension Fund. The Bank has a representative on its board.

Risk analysis and risk management

Broadly speaking, the Central Bank's risk may be divided into four areas: management risk, reputational risk, financial risk and operational risk. Management risk involves decisions in connection with monetary policy implementation and the Bank's other mandatory responsibilities. Although difficult to define precisely, it is determined by factors including management competence, working processes and internal controls. Reputational risk concerns the Central Bank's credibility and may be crucial for the Bank itself and even the financial system as a whole. Financial risk mainly lies in credit risk, interest rate risk, liquidity risk and exchange rate risk, in connection with the maintenance of foreign reserves and monetary policy implementation. Internal rules are in effect on the maintenance and investment of foreign reserves and are reviewed by the Board of Governors at regular intervals and confirmed by the Supervisory Board. Rules address investment strategy, investment options, eligibility, duration of securities and the share of liquid assets in foreign reserves. Operational risk is divided into several subcategories including employee risk, accounting risk, technical risk and the general operational risk posed to the Central Bank's activities.

Efforts are made to minimise risk in the work and responsibilities of all the Bank's departments, by such means as internal rules, work processes, job descriptions and internal audit.

National Festival Fund

The National Festival Fund operated for its 29th year in 2006. Its founding capital was the proceeds from the Central Bank's commemorative coin issue for the National Festival of 1974, and its revenue base has been the Bank's proceeds from other commemorative coins since then. One of the Fund's five board members, and its secretary, are appointed by the Central Bank. The board was appointed for a four-year term in 2006. The board decided to award 2.6 m.kr. in grants in 2006, to 21 applicants. The Fund's capital was just over 94 m.kr. at the end of the year.

On December 9, 2006, at the instigation of the National Festival Fund board, a parliamentary resolution was passed mandating the board to pay out the fund's entire capital over the next five years (2007-2011) in accordance with the purpose for which it was established, after which the fund will be formally closed.

The amount available to the fund to allocate in its annual grants will increase substantially as a result, enabling it to provide more effective support for interesting projects that have hitherto been beyond the scope of its resources.

Central Bank premises – library and archive

The Central Bank's premises at Kalkofnsvegur in Reykjavík also housed the Banks' Data Centre (RB) at the end of 2006. Most of the Central Bank library and archive is housed at Einholt 4 in Reykjavík. In 2006 the joint Central Bank and National Museum numismatic collection was moved from Einholt 4 to exhibition space on the ground floor of Kalkofnsvegur. A library of journals and reference books is also housed on the premises. The Central Bank's extensive library on the Icelandic economy and industry has been incorporated into the National and University Library of Iceland computerised card catalogue. It had 23,700 entries in the catalogue at the end of 2006.



V Accounts and organisation

Central Bank accounting principles

According to Article 32 of the Central Bank of Iceland Act No. 36/2001, the preparation of the annual accounts "shall be in accordance with the law and with recognised accounting principles. The Prime Minister shall lay down further rules on the accounting principles and preparation of the annual accounts." The current rules were set in 2005. The financial statements for 2006 are based on the same principles as in 2005. The only changes involve a new definition and presentation of interest income and interest expense in the profit and loss account. Changes in the presentation are explained in the notes to the financial statements on p. 45 of this report.

Operating results and balance sheet

According to its profit and loss account, the Central Bank of Iceland made a net profit of 11,857 m.kr. in 2006, compared with a loss of 2,819 m.kr. in the previous year. The profit is explained almost entirely by an exchange rate gain amounting to 11,825 m.kr. In 2005, the exchange rate loss amounted to 2,633 m.kr. Excluding exchange rate gain and loss, in 2006 the Central Bank produced a profit of 48 m.kr. before the transfer to the Treasury, compared with a loss of 186 m.kr. the year before. Interest income increased by 225% on domestic assets and on foreign assets by 46% in 2006. Total interest income grew by 162% over the year. Interest expense increased by 178% in 2006, almost entirely on account of domestic liabilities. In total, interest income increased by 15,671 m.kr. and interest expense by 13,743 m.kr. to leave net interest income of 1,929 m.kr., compared with 1,032 m.kr. in 2005. Operating expenses, i.e. salary and payroll expenses and other operating expenses, were 1,526 m.kr., depreciation 90 m.kr. and a supplementary contribution to the Bank Employees' Pension Fund 386 m.kr. Pursuant to provisions in the Central Bank Act, the transfer to the Treasury is calculated as one-third of net profit, i.e. 16 m.kr. Profit after transfer to the Treasury but excluding exchange rate gain therefore amounted to 32 m.kr.

In 2006, the Central Bank's balance sheet total increased by 159 b.kr. to 322 b.kr. at the end of the year. Two factors account for this large growth. The Central Bank's claims on deposit money banks and other financial institutions increased by 59 b.kr., and its foreign assets by 101 b.kr., which was the joint result of a €1 billion loan taken by the Treasury to boost the foreign reserves and the impact of the depreciation of the króna on the nominal amount of the reserves denominated in domestic currency. On the liability side, notes and coin in circulation grew by 10% to 14,513 m.kr. and the Central Bank's liabilities towards deposit money banks, in particular their current account deposits, by just over 10 b.kr. Total deposits in current accounts in the Central Bank rose by 135 b.kr. from the end of 2005 to the end of 2006, to 211 b.kr. The balance on Government current accounts increased by 47 b.kr. and the deposit in the currency account, representing the Treasury's euro loan, amounted

to 94 b.kr. at the end of the year. Other government deposits in the Central Bank included time deposits amounting to 33 b.kr., which is part of the proceeds deposited when Iceland Telecom was privatised, as discussed in the Central Bank's Annual Report for 2005. At the end of 2006, foreign assets accounted for 52% of the Central Bank's total assets, as against 42% at the end of the previous year. Foreign and foreign currency-denominated liabilities represented 31% of the Central Bank's total liabilities and equity at the end of 2006, compared with just under 7% at the end of 2005.

At the end of the year, the Central Bank's equity amounted to 48,227 m.kr., an increase of 11,857 m.kr. from the end of the year before.

As mentioned above, the Republic of Iceland borrowed €1 billion in international capital markets in 2006 in order to boost the Central Bank's external position. All the proceeds from the loan were deposited in a currency account in the Central Bank. The Treasury earns interest on the deposit at a rate matching that of the foreign loan. The budget for 2007 authorises the Treasury to allocate up to half of the proceeds from the loan towards strengthening the Central Bank's capital position. The Central Bank pays the same rate of interest on government current accounts as on credit institutions' current accounts. On the time accounts in which the proceeds from the privatisation of Iceland Telecom were deposited, the interest rate corresponds to the average of Central Bank current account rates and its policy rate.

Returns on foreign investments in 2006 were satisfactory under the circumstances, cf. Chapter IV. Interest rates remained low in international markets although they have risen somewhat from their trough. Rising interest rates lowered the market value of the bond portfolio and thereby the return over the year. Investment of the foreign reserves is explained in detail in Chapter IV and also covered in the notes to the financial statements.

Maintaining foreign reserves exposes the Central Bank to currency risk from changes in the exchange rate of the króna against which it is unable to hedge – and increasingly so, the larger the reserves. On the other hand, changes in the exchange rate of the króna have no effect on the value of the reserves denominated in foreign currency. They serve their purpose irrespective of changes in the exchange rate of the domestic currency. The Central Bank's foreign assets and liabilities are entered in the accounts at market price, translated into domestic currency at the end of the year. Changes in the exchange rate have a direct impact on its calculated profit. Foreign exchange rate loss and gain are expensed or credited in full in the profit and loss account, directly affecting the Bank's result.

The Central Bank's accounts along with detailed explanatory notes for individual items are presented later in this report.

Supervisory Board

The Central Bank Act No. 36/2001 stipulates that there shall be seven members of the Supervisory Board, to be elected following a parliamentary election. At the end of 2006, the Supervisory Board comprised Helgi S. Guðmundsson (Chairman), Ólafur G. Einarsson



(Deputy Chairman), Hannes Hólmsteinn Gissurarson, Jón Þór Sturluson, Jónas Hallgrímsson, Ragnar Arnalds and Sigríður Stefánsdóttir. Ólafur G. Einarsson, who had been Chairman of the Supervisory Board since 1998, stepped down from that position in April 2006. Helgi S. Guðmundsson was elected Chairman in his place. The Supervisory Board held 22 meetings in the course of 2006.

Board of Governors

Jón Sigurðsson resigned as Governor of the Central Bank of Iceland in June 2006 when he was appointed Minister of Industry and Commerce in the government of PM Geir H. Haarde. He had been a member of the Board of Governors since October 1, 2003. Assistant Governor Ingimundur Friðriksson was temporarily appointed Governor in Jón Sigurðsson's place from June 15 to August 31, 2006, then appointed Governor for a seven-year term from September 1, 2006. Other Governors were Davíð Oddsson, who is Chairman, and Eiríkur Guðnason. Eiríkur Guðnason's term of appointment as Governor expires at the end of April 2012 and Davíð Oddsson's in October 2012.

Central Bank organisation

Under a reorganisation in 2006, two of the main departments of the Central Bank – the International and Monetary departments – were merged to create a single International and Market Operations Department. At the same time, the IT Unit was transferred from Operations to Statistics, which was renamed Statistics and IT.

Human resources

Considerable changes took place in Central Bank staffing during 2006. Fifteen employees left or retired from the Bank and ten were hired, making a net reduction of five since 2005. The number of summer employees was similar to previous years. Sveinn Erling Sigurðsson retired as Director of Statistics during the year. Other retirees were: Birna Friðriksdóttir, Cash Unit; Brynjólfur Samúelsson, Operations; Eiður H. Einarsson, Statistics; and Ingibjörg Jakobsdóttir, Cash Unit. The organisational changes described in Chapter IV reduced the number of posts of Department Director by one, and no Assistant Governor was appointed after the former incumbent was appointed Governor. The Chief Auditor, who is appointed by the Supervisory Board, Lilja Steinþórsdóttir, left the Bank and Stefán Svavarsson was appointed to the position. Tómas Örn Kristinsson, formerly Director of the Monetary Department which was merged to form the International and Market Operations Department, was appointed Director of Statistics and IT, which was formed by the merger of the Statistics Department and IT unit.

The number of positions increased by one each at the Operations and Statistics and IT departments, but decreased by three at the International and Market Operations Department, by two at the Financial Stability Department, and by one each at the Governors' Office and Economics Department.

At the end of the year the Bank had 111 employees – 61 males and 50 females – five fewer than at the end of 2005. The number

Table V-1. Employees

	No.	Man-years
Secretariat	10	9.5
Governors' Office	3	3.0
Legal Services	2	2.0
Library and Collection	5	4.5
International and Market Operations Department	8	8.0
Accounting Department	10	10.0
Financial Stability Department	13	13.0
Financial Stability	6	6.0
Cashier's Unit	7	7.0
Economics Department	15	15.0
Operations Department	36	28.1
Statistics and Information	17	16.2
Internal Auditing Department	2	2.0
Total	111	101.8



of full-time equivalent positions was 101.8. Three employees were in part-time posts equivalent to 2.2 positions, and the Banks' Data Centre was responsible for 7 of the 14 positions in the joint cafeteria, security and maintenance and janitorial services it shares with the Central Bank. Average man-years were 112.6, a decrease of 3.3 from 2005.

Wage agreements

Most Central Bank employees are members of the Federation of Bank Employees and are paid salaries according to its wage agreements. The current wage settlement is in force until September 2008. It provides for pay rises of 3% on January 1, 2007 and 2.25% on January 1, 2008.

Equal opportunities committee

The Board of Governors confirmed the Bank's equal opportunities strategy in 1996. An equal opportunities committee has been active since then. The equal opportunities strategy has been reviewed regularly, most recently in 2005.



Meeting of the Supervisory Board in August 2006, left to right: Arnór Sighvatsson, Davíð Oddsson, Hannes Hólmsteinn Gissurarson, Jónas Hallgrímsson, Ólafur G. Einarsson, Helgi Guðmundsson, Sigríður Stefánsdóttir, Jón Þór Sturluson, Ragnar Arnalds, Eiríkur Guðnason, Ingimundur Friðriksson and Tómas Örn Kristinsson.

Central Bank of Iceland December 31, 2006

Supervisory Board

Principal members

Helgi S. Guðmundsson, Chairman
 Ólafur G. Einarsson, Deputy Chairman
 Hannes Hólmsteinn Gissurarson
 Jón Þór Sturluson
 Jónas Hallgrímsson
 Ragnar Arnalds
 Sigríður Stefánsdóttir

Alternates

Birna M. Olgeirsdóttir
 Ellert B. Schram
 Erna Gísladóttir
 Hilmar Gunnlaugsson
 Krístrún Heimisdóttir
 Sigfús I. Sigfússon
 Tryggvi Friðjónsson

Board of Governors

Davíð Oddsson, Governor and Chairman
 Eiríkur Guðnason, Governor
 Ingimundur Friðriksson, Governor

Principal Officers

Director of International and Market Operations Department:	Sigurður Sturla Pálsson
Chief Accountant:	Erla Árnadóttir
Chief Auditor:	Stefán Svavarsson
Director of Financial Stability Department:	Tryggvi Pálsson
Chief Economist:	Arnór Sighvatsson
Chief Attorney:	Sigríður Logadóttir
Director of Operations:	Ingvar A. Sigfússon
Director of Statistics and IT:	Tómas Örn Kristinsson

Employees

SECRETARIAT

Governors' Office

Ágústa Johnson
Ellen Hrefna Haraldsdóttir
Stefán Jóhann Stefánsson

Legal Services

Sigfús Gauti Þórðarson
Sigríður Logadóttir

Library and Collection

Anton Holt
Magný Gyða Ellertsdóttir
Sigurbjörg Sigurðsson
Unnur Björk Lárusdóttir
Valborg Stefánadóttir

INTERNATIONAL AND MARKET OPERATIONS DEPARTMENT

Bergur Barðason
Björn G. Ólafsson
Gerður Ísberg
Hallgrímur Ólafsson
Helga Rún Helgadóttir
Lilja D. Alfreðsdóttir
Oddgeir Gunnarsson
Sigurður Sturla Pálsson

ACCOUNTING DEPARTMENT

Alf H. Pedersen
Anna S. Árnadóttir
Arndís Leifsdóttir
Árni Þórðarson
Erla Árnadóttir
Guðrún E. Herbertsdóttir
Halldóra Konráðsdóttir
Ísólfrur Sigurðsson
Jónína Guðbjartsdóttir
Ólöf Jónsdóttir

INTERNAL AUDITING DEPARTMENT

Guðmundur Björnsson
Stefán Svavarsson

FINANCIAL STABILITY DEPARTMENT

Guðmundur Kr. Tómasson
Guðrún Ögmundsdóttir
Jónas Þórðarson
Pálína Kristinsdóttir
Perla Ösp Ásgeirsdóttir
Tryggvi Pálsson

Cashier's Unit

Auður Gísladóttir
Hannes Haraldsson

Ingveldur S. Kristjánadóttir
Jóhanna Pétursdóttir
Kolbrún Jóhannsdóttir
Kristján Guðmundsson
Stefán Arnarson

ECONOMICS DEPARTMENT

Arnór Sighvatsson
Ásgeir Daníelsson
Daníel Svavarsson
Guðmundur Guðmundsson
Guðrún Yrsa Richter
Helga Guðmundsdóttir
Karen Á. Vignisdóttir
Kristjón Kolbeins
Magnús Fjalar Guðmundsson
Markús Möller
Ólafur Örn Klemensson
Ragnhildur Jónsdóttir
Rannveig S. Sigurðardóttir
Þorvarður Tjörvi Ólafsson
Þórarinn G. Pétursson

OPERATIONS DEPARTMENT

Anna María Pétursdóttir
Bernard Scudder
Birna K. Jónsdóttir
Hólmfríður M. Ingibergsdóttir
Ingvar A. Sigfússon
Þórður Gautason

Maintenance and Janitorial Services

Berglind Þorsteinsdóttir
Bylgja Þorvarðardóttir
Dóra Matthíasdóttir
Eygló Ingvadóttir
Guðný Harpa Hallgrímsdóttir
Kristinn Unnarsson
Marteinn Jóhannesson
Ólafía Egilsdóttir
Sigrún Jónsdóttir
Sigurlaug Jósepsdóttir
Sólveig Kristinsdóttir
Stefanía Hrönn Guðnadóttir
Svala Sigurðardóttir

Cafeteria

Bergþóra Óskarsdóttir
Guðlaug Erla Ingólfssdóttir
Halla Kristín Björnsdóttir
Sigríður Laufey Guðmundsdóttir
Sigurberg Jónsson

Design and Printing

Hólmgeir H. Hákonarson
Klara Jóhannsdóttir
Sigríður María Jónsdóttir
Sigurborg Steingrímsdóttir
Sveinn A. Blöndal

Secretaries

Sigríður Bogadóttir
Þórey Þórarinsdóttir

Archives

Eva Sóley Sigurðardóttir
Guðrún Sigmarsdóttir
Hilmar Gunnþór Garðarsson
María Jenný Jónasdóttir
Sigurborg Ólafsdóttir
Sveinbjörg Rut Helgadóttir

Transport

Garðar Halldórsson
Karl G. Smith

Security

Guðleifur Svanbergsson
Gunnlaugur Magnússon
Hannes Ólafsson
Jóhann Gunnar Friðjónsson
Sigurður Sigurðsson
Sveinbjörn Kristjánsson
Þorsteinn Þorvaldsson

STATISTICS AND IT DEPARTMENT

Arnar Freyr Guðmundsson
Bryndís Ásbjarnardóttir
Bryndís Pétursdóttir
Einar Örn Ólafsson
Eva Hjördís Bjarnadóttir
Guðmundur Harðarson
Hrönn Helgadóttir
Indriði I. Stefánsson
Jakob Gunnarsson
Kristjana Baldursdóttir
Mark R. Eldred
Pétur Örn Sigurðsson
Ríkarður B. Ríkarðsson
Sigurður Kr. Sigurðsson
Tómas Örn Kristinsson
Tryggvi Eyvindsson
Örn Jónasson



FINANCIAL STATEMENTS 2006

Confirmation by the Supervisory Board and the Board of Governors

The Supervisory Board and the Board of Governors of the Central Bank of Iceland hereby confirm the Bank's financial statements for the year 2006 with their signatures.

Reykjavík, February 22, 2007

Supervisory Board

Helgi S. Guðmundsson
Chairman

Ólafur G. Einarsson
Hannes Hólmsteinn Gissurarson
Jón Þór Sturluson

Jónas Hallgrímsson
Ragnar Arnalds
Sigríður Stefánsdóttir

Board of Governors

Davíð Oddsson
Chairman

Eiríkur Guðnason

Ingimundur Friðriksson

Auditor's Report

The National Audit Office has audited the financial statements of the Central Bank of Iceland for the year ended December 31, 2006. These financial statements comprise a profit and loss statement, balance sheet, statement of cash flows and notes no. 1-15. These financial statements are the responsibility of the Bank's management. The National Audit Office's responsibility is to express an opinion on these financial statements based on our audit.

Our audit was made in accordance with generally accepted auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the financial statements are free of material misstatement. The audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. The audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. The National Audit Office believes that our audit provides a reasonable basis for our opinion.

In the National Audit Office's opinion, the accompanying financial statements give a true and fair view of the financial position as at December 31, 2006, and the results of operations and cash flow for the year then ended, in conformity with the law and regulations on Central Bank accounting and its annual accounts.

Reykjavík, February 22, 2007

Sigurður Þórðarson
Auditor General

Confirmation by the Prime Minister of Iceland

With reference to the statements of the auditor, the Supervisory Board and the Board of Governors, the financial statements are hereby ratified.

Reykjavík, March 30, 2007

Geir H. Haarde
Prime Minister

Profit and Loss Account for the year ended 31 December 2006

	Notes	2006	2005
Interest income			
On domestic loans		12,631,734	3,890,736
On foreign deposits and securities		3,039,505	2,086,216
		<u>15,671,239</u>	<u>5,976,952</u>
Interest expense			
On deposits		13,658,417	4,891,769
On foreign liabilities		84,112	46,622
		<u>13,742,529</u>	<u>4,938,391</u>
Net interest income	1, 13	1,928,710	1,038,561
Other income and expenditure			
Income from services		220,664	144,589
Expenditure on services		(83,016)	(47,385)
Income from shareholdings, etc.	2	452,341	27,828
Revaluation of foreign securities	1	(1,067,011)	(452,439)
Revaluation of gold reserve	1	525,927	298,152
Exchange rate gain on foreign currency transactions....		72,144	95,279
		<u>121,049</u>	<u>66,024</u>
Net operating income		2,049,759	1,104,585
Other operating expenditure			
Salaries and payroll costs	7, 9, 14	890,258	813,008
Other operating expenses	10	635,637	387,725
Depreciation for the year	4	90,246	90,261
Supplementary pension fund contribution		385,662	0
		<u>2,001,803</u>	<u>1,290,994</u>
Profit (loss) before transfer to Treasury		47,956	(186,409)
Transfer to Treasury	8	15,985	0
Profit (loss) excluding exchange rate loss/gain		31,971	(186,409)
Exchange rate gain (loss)	14	11,825,022	(2,632,621)
Net profit (loss) for the year	11	<u>11,856,993</u>	<u>(2,819,030)</u>

Balance Sheet at December 31, 2006

ASSETS

	Notes	2006	2005
Foreign assets			
Foreign deposits		41,649,443	21,048,708
Gold	3	2,934,064	2,073,527
Foreign securities		121,246,719	42,474,693
Currency balance with the IMF	5	2,019,865	1,680,986
Assets not included in foreign reserves	2	522,496	227,627
		<u>168,372,587</u>	<u>67,505,541</u>
Domestic assets			
<i>Deposit money banks</i>			
Collateral loans	6	119,862,706	77,772,034
<i>Other financial institutions</i>			
Listed securities		1,472,558	1,832,121
Collateral loans	6	27,073,964	10,069,962
		<u>28,546,522</u>	<u>11,902,083</u>
<i>Other</i>			
Miscellaneous accounts	2	47,207	150,786
Securities		95,313	37,758
		<u>142,519</u>	<u>188,544</u>
<i>Fixed assets</i>			
Property and equipment	1, 4	4,859,244	4,926,055
		<u>4,859,244</u>	<u>4,926,055</u>
		<u>153,410,991</u>	<u>94,788,716</u>
		<u>321,783,578</u>	<u>162,294,257</u>
Off-balance sheet items	12		

All amounts in thousand kr.

Balance Sheet at December 31, 2006

LIABILITIES AND EQUITY

	Notes	2006	2005
Foreign liabilities			
Short-term		94,644	149,657
Counterpart of SDR allocated by the IMF	5	1,779,605	1,484,141
		<hr/>	<hr/>
Foreign liabilities		1,874,249	1,633,798
Domestic liabilities			
Notes and coin		14,512,501	13,201,909
<i>Deposit money banks</i>			
Sight deposits including required deposits	6	43,210,188	31,955,976
Certificates of deposit		1,777,253	2,294,138
		<hr/>	<hr/>
		44,987,441	34,250,114
<i>Other financial institutions</i>			
Sight deposits including required deposits	6	129,825	144,988
<i>Central government</i>			
Government, deposits		80,114,201	33,572,676
Time deposits		33,085,333	32,858,889
Foreign deposits		3,459,663	9,112,649
Foreign time deposits		93,775,409	0
Government institutions, deposits		567,120	371,389
		<hr/>	<hr/>
		211,001,726	75,915,603
<i>Other liabilities</i>			
Treasury		15,985	-
Miscellaneous		677,513	438,069
Pension fund obligations	7	357,541	339,971
		<hr/>	<hr/>
		1,051,039	778,040
		<hr/>	<hr/>
Domestic liabilities		271,682,532	124,290,654
Equity			
Capital		13,501,000	13,501,000
Revaluation of property and equipment		4,990,681	4,990,681
Other reserves		29,735,116	17,878,124
		<hr/>	<hr/>
Equity	11	48,226,797	36,369,805
Total liabilities and equity			
		<hr/>	<hr/>
		321,783,578	162,294,257
		<hr/>	<hr/>
Off-balance sheet commitments	12		

Statement of Cash Flows for the year 2006

CASH FLOWS FROM OPERATING ACTIVITIES:	Notes	2006	2005
Profit (loss) for the year		11,856,993	(2,819,030)
Operating activities not affecting cash flows:			
Depreciation of fixed assets	4	90,246	90,261
Price indexation and foreign exchange (gain) on assets		(1,510,511)	(540,674)
Foreign exchange loss (gain) on liabilities		5,036,415	(60,066)
Foreign exchange loss (gain) on liquidity position	4	(16,530,520)	2,751,486
Change in assets and liabilities related to operating activities		539,867	191,236
Net cash from (to) operating activities		(517,510)	(386,787)
INVESTING ACTIVITIES:			
Gold, (increase)		0	(10,923)
Foreign securities, decrease (increase)		577,448	(77,880)
Collateral loans, (increase)		(59,094,674)	(50,357,570)
Miscellaneous accounts, decrease		0	1,625,017
Fixed assets, (increase)		(24,635)	(25,634)
Net cash to investing activities		(58,541,861)	(48,846,990)
FINANCING ACTIVITIES:			
Foreign borrowing, (decrease)		0	(16,469)
Notes and coin, increase		1,310,592	1,569,601
Treasury time deposits, increase		0	32,858,889
Foreign time deposits, increase		89,034,458	0
Certificates of deposit, (decrease)		(516,885)	(2,109,673)
Other		0	(2,927)
Net cash from financing activities		89,828,165	32,299,421
Change in liquidity		30,768,794	(16,934,356)
Foreign exchange gain (loss) on liquidity		16,530,520	(2,751,486)
Liquidity at beginning of year		(9,958,928)	9,726,914
Liquidity at end of year (liquidity position)	1	37,340,386	(9,958,928)
LIQUIDITY POSITION:			
Foreign deposits and securities		164,916,027	65,204,387
Deposits of deposit money banks		(43,434,657)	(32,250,622)
Deposits of central government		(84,140,984)	(42,912,693)
		37,340,386	(9,958,928)

Notes to the Financial Statements

1. The financial statements have been prepared in accordance with the Annual Accounts Act No. 3/2006, the provisions of Act No. 161/2002 on Financial Undertakings and Rules No. 1088/2005 on Central Bank Accounting and Annual Accounts.
 - Assets and liabilities in foreign currency are translated into Icelandic króna (kr.) using the exchange rate at the end of 2006. Income and expense in foreign currency are converted using the exchange rate on the date of transaction. Exchange rate gain/loss is posted to the Profit and Loss Account.
 - Assets and liabilities linked to price indices are shown in the Balance Sheet with accrued indexation at year-end, stated according to the relevant index figures for January 2007. Indexation is entered in the Profit and Loss Account under *Interest income/On domestic loans*.
 - Income is entered when earned, whether or not it has been collected. Likewise, expenses are entered when incurred, whether or not they have been paid. Changes in the valuation of securities are also entered in the Profit and Loss Account regardless of whether they are realised or unrealised.
 - In the statement of cash flows, liquidity is defined as assets and liabilities that are liquifiable within two working days. Accordingly, foreign deposits and securities are included among liquidity, together with deposits of deposit money banks and central government.
 - The presentation of a number of income and expense items has been altered from earlier financial statements. Revaluation of foreign reserve securities and the gold reserve is now entered under *Other income* but was previously classified under *Interest income* or *Interest expense*. The same applies to gains on the sale of foreign currency. Exchange rate gain or loss is now shown separately as the final item in the Profit and Loss Account, instead of being incorporated into *Interest income* or *Interest expense* as applicable. Exchange rate revaluations are not included in calculations of the transfer to the Treasury.
 - Shares held by the Central Bank have hitherto been entered at purchase price, since they have not been listed on a market. When the Nordic OMX stock exchange holding company acquired Eignarhaldsfélag Verðbréfaþings hf., the Iceland Stock Exchange holding company, towards the end of 2006, it paid shareholders in the latter, including the Central Bank of Iceland, with its own shares. Since these are listed on an official market they are entered at market price at year-end and the revaluation is posted to *Other operating income*.
 - The cost of printing banknotes and minting coins is expensed when incurred. In the Financial Statements for 2005 this cost was posted to assets, but this method has now been discontinued.

Accounting policies

- Fixed assets at the end of 2005 are valued at market price less subsequent depreciation. Fixed assets purchased in 2006 are valued at cost price less depreciation which is calculated based on cost price less expected salvage value.
- In other respects, accounting is conducted according to the same principles as in the past.

Holdings

2. The Bank's holding in the Bank for International Settlements (BIS) is entered at cost price. At the end of the year, the Bank held 1,070 shares in BIS in the amount of 5,000 SDR each. This holding is entered under the item *Foreign assets/Assets not included in foreign reserves*. The book value at the end of 2006 amounted to 184.5 m.kr. and the nominal value 172.4 m.kr. (1.6 m. SDR). Of the Central Bank's 1,070 shares, 750 have not been paid up but the Bank is obliged to pay the outstanding value if they are called.

Foreign assets/Assets not included in foreign reserves includes the Bank's shares in OMX to a market value of 299.5 m.kr. at the end of 2006. The total number of shares is 228,259 and their market rate was 126 at the end of 2006. A revaluation to the amount 293.9 m.kr. was posted as income in the Profit and Loss Account. The item *Other/Miscellaneous accounts* includes the Bank's 8% equity interest in the Fjölgreiðslumiðlun hf. netting service provider. The book value of this holding is 1.2 m.kr., which is also the nominal value.

Foreign assets and gold

3. The Bank's foreign assets amounted to 168.4 b.kr. at the end of 2006 but were 67.5 b.kr. at the end of the previous year. The figure includes the gold reserves of the Central Bank which amounted to 64,408 troy ounces. Gold at year-end 2006 was valued at the market price of 635.7 USD per troy ounce, which was equivalent to 45,554 kr. At the end of 2006 the Bank's gold reserves therefore amounted to 2.9 b.kr.

The Bank's foreign reserves were increased at the end of 2006 by almost €1bn., which was financed with a five-year loan taken by the Treasury. It is planned to convert part of the Treasury foreign time deposit into a capital contribution, but the amount has not yet been announced. Euro-denominated bonds were purchased for the amount of the deposit.

Return by currency on bonds and deposits in the foreign reserves during the year was as follows:

	<i>Bonds</i>	<i>Deposits</i>
US dollars.....	4.07%	4.93%
Euro	1.12%	2.82%
Sterling	2.15%	4.70%

4. Fixed assets were entered at valuation price in 2005. Assets purchased in 2006 are depreciated using the straight-line method to allocate cost price to their residual values over their estimated useful lives.

Fixed assets at the end of 2006 are specified as follows (in m.kr.):

	<i>Land</i>	<i>Real estate</i>	<i>Equip./ furnish.</i>	<i>Collec- tions</i>	<i>Total</i>
<i>Assets:</i>					
Balance 1/1	24.0	4,575.3	193.9	237.0	5,030.2
Purchased in 2006			26.5	1.3	27.8
Sold in 2006			(5.0)		(5.0)
	<u>24.0</u>	<u>4,575.3</u>	<u>215.4</u>	<u>238.3</u>	<u>5,053.0</u>
<i>Accumulated depreciation:</i>					
Balance 1.1.2006		48.2	55.9		104.1
Depreciation during the year		48.3	42.0		90.3
Depreciation of sold assets			(0.6)		(0.6)
	<u>0.0</u>	<u>96.5</u>	<u>97.3</u>	<u>0.0</u>	<u>193.8</u>
Book value at end-2006	<u>24.0</u>	<u>4,478.8</u>	<u>118.1</u>	<u>238.3</u>	<u>4,859.2</u>
Depreciation ratio	0%	1,25-3%	10-33%	20%	
Land Registry valuation					
31.12.2006	0.4	3,690.5			3,690.9
Insurance valuation					
31.12. 2006		4,113.5	351.4	347.4	4,812.3

5. Iceland's quota with the International Monetary Fund amounted to 117.6 million SDR at the end of 2006. One-quarter was originally paid with a gold contribution and the rest in Icelandic currency. The Bank's reserve tranche position with the Fund was 18.6 million SDR, which is the balance between the quota and the IMF's total króna currency holdings from the Bank (see table). Iceland's SDR allocation with the Fund amounted to 16.4 million SDR.

<i>Assets:</i>	<i>M.SDR</i>	<i>M.kr.</i>
Central Bank of Iceland's quota	117.6	12,667.9
Total currency holdings	<u>(99.0)</u>	<u>(10,665.5)</u>
Reserve tranche position	18.6	2,002.4
Accrued interest on tranche	0.1	9.1
SDR deposit with IMF	<u>0.1</u>	<u>8.4</u>
	<u>18.8</u>	<u>2,019.9</u>
<i>Liabilities:</i>		
	<i>M.SDR</i>	<i>M.kr.</i>
SDR allocation with IMF	16.4	1,767.6
Currency holding, Account no. 2	0.0	0.1
Accrued interest on allocation	<u>0.1</u>	<u>12.0</u>
	<u>16.5</u>	<u>1,779.7</u>

Fixed assets

International Monetary Fund

Financial institutions

6. Credit institutions that are participants in the Central Bank Real-Time Gross Settlement system pledge collateral for payments in the system. Collateral is in the form of securities and liquid funds deposited in accounts at the Central Bank. The amount corresponds to the intraday overdraft for participants to meet fluctuations on their RTGS accounts.

At the end of 2006, market value of collateral securities in the RTGS system amounted to 24.6 b.kr.

Credit institutions pledge collateral to the custody of the Central Bank for their collateral loans in accordance with Rules No. 997/2004.

Pension commitments

7. According to actuarial valuations the Bank's total pension commitments towards former Governors of the Bank and their spouses, and towards the directors of the National Economic Institute for which it was responsible for half the costs, amounted to 358 m.kr. at the end of 2006. The Bank's contribution for the year 2006 was 37 m.kr. and is posted to the Profit and Loss Account under *Salaries and payroll costs*. The Bank's commitment increased by 18 m.kr. in 2006 and has been expensed.

Transfer to the Treasury

8. The Central Bank's transfer to the Treasury, according to Article 34 of the Central Bank Act No. 36/2001, is equal to two-thirds of its net profit (excluding exchange rate loss or gain) in the year, provided that its equity (excluding revaluation of assets) exceeds 2.25% of the outstanding lending and domestic securities stock of the credit system at the end of the year, but otherwise one-third. The Bank's equity was below this limit at the end of 2006. One-third of the profit is therefore transferred to the Treasury, amounting to 16 m.kr.

Emoluments of the Supervisory Board and Board of Governors

9. Total remuneration and fees to the Board of Governors and Supervisory Board amounted to 78.9 m.kr. in 2006. Governors are not remunerated for sitting on boards and committees that are established jointly by financial market institutions and companies or to which the Central Bank appoints representatives by law. Total emoluments of the Board of Governors and Supervisory Board in 2006 were as follows:

<i>Board of Governors</i>	<i>M.kr.</i>
Davið Oddsson.....	19.0
Birgir Ísleifur Gunnarsson	10.4
Eiríkur Guðnason.....	16.4
Jón Sigurðsson	11.1
Ingimundur Friðriksson	8.2
<i>Supervisory Board</i>	
Helgi S. Guðmundsson, Chairman from April 9	2.2
Ólafur G. Einarsson, Chairman until April 9	0.7
Other members, incl. alternates (12)	10.9
	<u>78.9</u>

10. The fee paid by the Central Bank to the National Audit Office for auditing the accounts and other audit services for 2006 amounted to 1.5 m.kr.
11. Over the past five years, the Bank's equity has developed as follows (in m.kr.):

	2006	2005	2004	2003	2002
Equity at beginning of year (excl. revaluation of assets)	31,379	34,198	40,217	40,254	34,327
Capital contribution					4,500
Profit (loss) excl. transfer and exchange rate gain/loss	48	(186)	487	1,898	4,696
Transfer to Treasury	(16)				(714)
Exchange rate gain (loss) over the year	11,825	(2,633)	(6,506)	(1,935)	(2,555)
Equity at end of year excl. revaluation	43,236	31,379	34,198	40,217	40,254
Revaluation of assets	4,991	4,991			
Equity at end of year	48,227	36,370	34,198	40,217	40,254
<i>Position at end of year in b.kr.</i>					
Total assets	321.8	162.3	106.6	87.3	116.7
Equity (excl. revaluation of assets)	43.2	31.4	34.2	40.2	40.3
Credit system domestic lending and securities	4,298.2	3,234.8	2,658.1	2,208.3	1,981.9
Equity/total assets	13.4%	19.3%	32.1%	46.0%	34.5%
Equity/credit system domestic lending and securities	1.0%	1.0%	1.3%	1.8%	2.0%

12. The Central Bank is committed to pay its 750 shares in BIS if they are called. Each share has a nominal value of 5,000 SDR and the total value is therefore 404 m.kr.

The Central Bank's equity interest in the Banks' Data Centre (RB) is not reflected in the accounts. In formal terms, this is a joint operation under the auspices of all banks and savings banks in Iceland, in accordance with an agreement to that effect. The partnership agreement states that the Central Bank's contribution was one-fifth of the Banks' Data Centre's starting capital. The book value of owners' equity in the Banks' Data Centre was 1.5 b.kr. at the end of 2006.

At the end of 2006 the Central Bank had access to committed credit facilities with foreign financial institutions in the amount of 275 million USD, which was equivalent to 19.7 b.kr.

Auditor's fee

Equity and net profit

Guarantees and off-balance-sheet commitments

Net interest income

13. Net interest income amounted to 1.6 b.kr. in 2006 compared with 1 b.kr. the previous year. The main explanation for the increase is higher foreign interest rates. Net interest income is specified as follows (in thous.kr.):

	2006	2005
<i>Domestic items</i>		
Transactions with credit institutions.....	9,432,339	1,927,219
Return on domestic securities	207,586	94,750
Central government deposits	(10,666,608)	(3,023,001)
	<u>(1,026,683)</u>	<u>(1,001,032)</u>
<i>Foreign items</i>		
Gold reserves	13,688	10,627
Foreign deposits	745,520	471,205
Foreign securities	2,196,185	1,557,761
	<u>2,955,393</u>	<u>2,039,593</u>
Net interest income	<u>1,928,710</u>	<u>1,038,561</u>

Exchange rate revaluation

14. Exchange rate gain for the year amounted to 11.8 b.kr., compared with a loss of 2.6 b.kr. in 2005. The exchange rate revaluation is calculated from the following balance sheet items (in thous.kr.):

	2006	2005
Gold	320,922	57,242
IMF accounts	38,812	(10,381)
Foreign deposits	6,522,344	(1,404,866)
Foreign securities	11,594,613	(1,848,846)
Foreign current liabilities	(148,188)	21,635
Dom. accounts in foreign currency ...	(6,503,481)	552,595
Total exchange rate gain (loss)	<u>11,825,022</u>	<u>(2,632,621)</u>

Salaries and payroll costs

15. At the end of the year the Bank had 111 employees – 61 males and 50 females – five fewer than at the end of 2005. The number of full-time equivalent positions was 101.8. Three employees were in part-time posts equivalent to 2.2 positions, and the Banks' Data Centre was responsible for 7 of the 14 positions in the joint cafeteria, security and maintenance and janitorial services it shares with the Central Bank. Average man-years were 112.6, a decrease of 3.3 from 2005. Salaries and payroll costs are specified as follows (in thousand kr.):

	2006	2005
Salaries	686,802	646,257
Payroll costs	138,257	129,380
Pension fund contributions	65,199	37,371
	<u>890,258</u>	<u>813,008</u>
Supplementary contribution to Bank Employees' Pension Fund	385,662	0
	<u>1,275,920</u>	<u>813,008</u>

An agreement was reached in 2006 between the Bank Employees' Pension Fund and its contributing employers on a final settlement with respect to the fund's commitments. The Central Bank was a party to this agreement and its share of the settlement was 385.7 m.kr. The agreement entails that no further payments will be made on account of the fund's pension commitments.

APPENDICES

Press releases 2006

No. 1	January 9, 2006	Central Bank's Balance Sheet at end-December 2005
- 2	January 23, 2006	Interest rate decision by the Board of Governors of the Central Bank of Iceland on Thursday, January 26 2006
- 3	January 26, 2006	Central Bank of Iceland raises its policy interest rate
- 4	January 26, 2006	The Central Bank of Iceland raises its policy interest rate by 0.25 percentage points
- 5	February 6, 2006	Central Bank's Balance Sheet at end-January 2006
- 6	February 21, 2006	Fitch Ratings revises Iceland's outlook to negative
- 7	March 6, 2006	Central Bank Balance Sheet at end-February 2006
- 8	March 7, 2006	Balance of payments in the fourth quarter of 2005 and the external position at the end of the year
- 9	March 16, 2006	Standard & Poor's affirms Iceland's sovereign rating and unchanged outlook
- 10	March 16, 2006	Income from the US Defence Force
- 11	March 30, 2006	The Central Bank of Iceland raises its policy interest rate
- 12	April 4, 2006	Moody's says that Iceland's solvency and liquidity are not at risk
- 13	April 6, 2006	Central Bank Balance Sheet at end-March 2006
- 14	April 7, 2006	New Chairman of the Supervisory Board
- 15	April 25, 2006	Publication of Financial Stability 2006
- 16	May 5, 2006	Central Bank Balance Sheet at end-April 2006
- 17	May 15, 2006	Concluding Statement by the IMF mission to Iceland 2006
- 18	May 18, 2006	The Central Bank of Iceland raises its policy interest rate
- 19	May 18, 2006	The Central Bank of Iceland raises its policy interest rate
- 20	May 31, 2006	Withdrawal of banknotes from circulation
- 21	June 5, 2006	Standard & Poor's Revises Republic of Iceland Outlook To Negative On Hard Landing Risk; Ratings Affirmed
- 22	June 6, 2006	Balance of payments in the first quarter of 2006 and the external position
- 23	June 7, 2006	Central Bank Balance Sheet at end-May 2006
- 24	June 16, 2006	Changes in the Board of Governors of the Central Bank of Iceland
- 25	June 29, 2006	Ingimundur Friðriksson appointed Governor of the Central Bank of Iceland
- 26	July 6, 2006	The Central Bank of Iceland raises its policy interest rate
- 27	July 6, 2006	Central Bank Balance Sheet at end-June 2006
- 28	August 3, 2006	Moody's issues annual report on Iceland
- 29	August 4, 2006	Central Bank Balance Sheet at end-July 2006
- 30	August 8, 2006	IMF Concludes 2006 Article IV Consultation with Iceland
- 31	August 16, 2006	The Central Bank of Iceland raises its policy interest rate
- 32	August 16, 2006	The Central Bank of Iceland raises its policy interest rate
- 33	September 5, 2006	Balance of payments in the first half of 2006 and the external position
- 34	September 6, 2006	Organisational changes at the Central Bank of Iceland
- 35	September 6, 2006	Central Bank Balance Sheet at end-August 2006
- 36	September 14, 2006	The Central Bank of Iceland raises its policy interest rate
- 37	September 14, 2006	The Central Bank of Iceland raises its policy interest rate
- 38	October 23, 2006	New Internal Auditor
- 39	November 2, 2006	The Central Bank of Iceland leaves its policy rate unchanged
- 40	November 3, 2006	Borrowing to strengthen the foreign reserves
- 41	November 9, 2006	Fitch Affirms Iceland at AA-/AAA; Outlook Negative
- 42	November 22, 2006	Republic of Iceland Eurobond issue
- 43	November 30, 2006	New exchange rate indices
- 44	December 1, 2006	Indicative exchange rates
- 45	December 5, 2006	Balance of payments in the third quarter of 2006 and the external position

No. 46	December 21, 2006	The Central Bank of Iceland raises its policy interest rate
- 47	December 21, 2006	The Central Bank of Iceland raises its policy interest rate
- 48	December 22, 2006	Republic of Iceland Cut To FC A+/A-1, LC AA/A-1+ On Unbalanced Policy Mix; Outlook Stable (Standard & Poor's)

Publications by the Central Bank of Iceland in 2006

In English:

Annual Report 2005

Monetary Bulletin 2006, three issues

Financial Stability 2006

The Economy of Iceland 2006

Central Bank of Iceland Working Papers No. 29: The residential housing market in Iceland: Analysing the effects of the recent mortgage market restructuring, by Lúðvík Elíasson and Þórarinn G. Pétursson.

Central Bank of Iceland Working Papers No. 30: Simple efficient policy rules and inflation control in Iceland, by Ben Hunt.

Central Bank of Iceland Working Papers No. 31: The New Keynesian Phillips Curve: In Search of Improvements and Adaptation to the Open Economy, by Þorvarður Tjörvi Ólafsson.

Central Bank of Iceland Working Papers No. 32: QMM. A Quarterly Macroeconomic Model of the Icelandic Economy, by Ásgeir Daniéls-son, Lúðvík Elíasson, Magnús F. Guðmundsson, Björn A. Hauksson, Ragnhildur Jónsdóttir, Þorvarður Tjörvi Ólafsson and Þórarinn G. Pétursson.

Economic Indicators, eleven issues

In Icelandic:

Ársskýrsla 2005

Fjármálatíðindi 2006

Fjármálastöðugleiki 2006

Peningamál 2006, three issues

Hagvísar Seðlabanka Íslands, eleven issues

All these publications are also posted on the Central Bank of Iceland website.

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Table 1 Survey

<i>Main economic indicators</i>		1998	1999	2000	2001	2002	2003	2004	2005	2006
Gross domestic product ¹	% change year-on-year	5.8	4.0	4.4	3.6	-0.3	2.7	7.7	7.5	4.0
National expenditure ¹	% change year-on-year	13.3	4.2	6.0	-2.4	-2.8	6.1	9.9	15.8	6.2
Exports ¹	% change year-on-year	2.5	3.9	4.3	7.4	3.8	1.6	8.4	7.1	-2.9
Imports ¹	% change year-on-year	23.4	4.4	8.6	-9.1	-2.6	10.8	14.4	28.9	4.6
Current account balance ¹	% of GDP	-6.8	-6.8	-10.2	-4.4	1.6	-4.8	-9.9	-16.1	-20.8
Terms of trade ¹	% change year-on-year	5.2	-0.7	-2.4	0.3	0.6	-4.1	-1.3	0.5	0.8
International investment position	% of GDP	58.2	68.4	90.2	98.5	98.4	95.8	125.9	158.6	186.2
Employment (man-years)	% change year-on-year	3.4	2.7	2.2	1.6	2.2	0.8	0.9	3.0	5.0
Unemployment	% of labour force	2.8	1.9	1.3	1.4	2.5	3.4	3.1	2.1	1.3
<i>Prices and wages</i>		<i>% change</i>								
Consumer price index	year-on-year	1.7	3.4	5.0	6.7	4.8	2.2	3.2	4.0	6.8
Wage index	year-on-year	9.4	6.8	6.6	8.8	7.2	5.6	4.7	6.8	9.5
Real wages (deflated by CPI)	year-on-year	7.6	3.3	1.6	2.0	2.3	3.4	1.4	2.6	2.6
<i>Asset prices</i>		<i>% change</i>								
Residential housing	Q4-on-Q4	7.8	22.2	13.3	3.1	7.5	9.1	23.3	31.0	5.0
Share prices	within year	9.8	47.4	-19.3	-11.2	16.7	56.4	58.9	64.7	15.8
<i>Money supply and credit</i>		<i>% change</i>								
M1	within year	20.2	19.3	4.4	-2.3	23.8	22.6	30.1	23.5	22.5
M3	within year	15.1	17.1	11.2	14.9	15.3	17.5	15.0	23.2	19.4
Credit system lending and market securities	within year	15.1	17.3	17.2	19.2	3.2	11.4	20.0	31.0	33.4
DMB lending	within year	30.3	23.0	50.0	12.6	0.8	14.8	39.5	37.0	40.0
<i>Exchange rate and real exchange rate</i>		<i>% change</i>								
Nominal effective exchange rate	year-on-year	-1.6	-0.2	0.1	20.1	-3.0	-6.0	-2.0	-10.3	11.7
Icelandic króna vis-à-vis US dollar	year-on-year	-0.2	-1.8	-8.2	-19.3	6.8	19.2	9.5	11.6	-9.9
Icelandic króna vis-à-vis euro (ECU '97-'98)	year-on-year	0.4	0.0	6.3	-17.0	1.5	-0.6	-0.5	11.5	-10.9
Real exchange rate: relative prices	year-on-year	1.8	2.6	3.9	-12.7	5.1	4.7	2.2	13.5	-6.4
Real exchange rate: relative ULC	year-on-year	3.4	4.9	3.3	-12.9	5.2	5.8	-2.5	12.0	0.0
<i>Central Bank rates</i>		<i>average</i>								
Banks' current accounts	% p.a.	3.0	3.8	5.9	6.8	5.5	2.9	3.7	7.7	9.0
Collateral loans	% p.a.	7.3	8.3	10.4	10.9	8.4	5.4	6.1	9.4	10.5
Overnight loans	% p.a.	8.5	9.3	11.5	12.3	10.7	7.8	8.3	11.0	12.0
<i>Yields in the money and bond market (ICEX)</i>		<i>average</i>								
ICEX-5Y-I	% p.a.	.	.	.	.	.	.	.	.	4.6
ICEX-3M-NI	% p.a.	.	.	.	.	.	.	.	.	12.1
ICEX-5Y-NI	% p.a.	.	.	.	.	.	.	.	.	8.5
5-year Treasury notes (non-indexed)	% p.a.	7.7	8.4	11.1	9.6	7.8	7.6	7.6	7.6	9.3
<i>Commercial banks' interest rates</i>										
Non-indexed secured loans	% p.a.	12.8	13.6	16.7	18.0	15.4	12.0	12.2	14.8	17.1
Indexed securities	% p.a.	8.8	8.6	9.5	10.2	10.1	9.1	8.0	7.2	6.9
Yield on new standard loans ²	% p.a.	13.5	14.2	17.5	.	.	.	.	.	.
Penalty interest ³	% p.a.	16.5	17.3	21.9	23.7	21.3	17.3	17.3	20.3	22.5
<i>International comparison</i>										
Economic growth in OECD countries	% p.a.	2.7	3.3	4.0	1.2	1.6	2.0	3.2	2.7	3.2
Inflation in OECD countries	% p.a.	3.9	3.3	4.0	3.5	2.5	2.5	2.4	2.6	2.6
<i>General government finances⁴</i>										
Treasury fiscal balance	% of GDP	1.1	2.5	2.5	0.6	-0.6	-1.7	1.3	5.6	4.9
Treasury net borrowing requirement	% of GDP	-0.9	2.2	0.3	-2.8	-1.3	1.6	2.6	8.5	-2.3
General government expenditure	% of GDP	41.0	42.1	41.9	42.8	44.3	46.4	45.4	43.2	42.8
General government fiscal balance	% of GDP	0.5	2.3	2.4	0.2	-0.8	-2.1	0.5	5.5	4.2
General government gross debt	% of GDP	47.7	43.0	39.1	44.4	43.4	40.2	35.9	26.6	34.0
General government net debt	% of GDP	30.7	23.7	21.9	24.9	23.8	23.6	22.9	11.1	11.1
Total government revenue	% of GDP	41.5	44.4	44.3	43.0	43.6	44.3	45.9	48.7	47.0

1. Preliminary data for 2004-2005. 2. Cf. Art. 10 of Act No. 25/1987. 3. Cf. Art. 10 of Act No. 25/1987 and (from July 2001) Art. 10 of Act No. 38/2001. 4. Data for 2006 based on Ministry of Finance estimates in January 2007, except for net borrowing requirement, which is estimated from cash-basis result.

Sources: Directorate of Labour, Iceland Stock Exchange, Land Registry of Iceland, OECD, Statistics Iceland, Central Bank of Iceland.

Table 2 Exchange rate indices

	Official exchange rate ¹ 31/12 1991 = 100	Average exchange rate index ² 31/12 1994 = 100			Real exchange rate ³ 2000 = 100			
		Average	Based on import	Based on export	Based on relative prices		Based on unit labour cost	
			weights	weights	Index	% change ⁴	Index	% change ⁴
1996	116.2	99.0	100.0	98.1	91.3	0.27	87.8	1.0
1997	114.7	97.7	98.3	97.2	92.2	0.97	89.2	1.6
1998	112.8	96.2	96.7	95.7	93.8	1.76	92.2	3.4
1999	112.6	96.0	96.5	95.6	96.3	2.60	96.8	4.9
2000	112.7	96.1	96.3	95.7	100.0	3.90	100.0	3.3
2001	135.4	115.4	115.1	115.3	87.3	-12.68	87.1	-12.9
2002	131.4	112.0	111.7	112.0	91.7	5.06	91.7	5.2
2003	123.5	105.3	104.8	105.4	96.0	4.66	97.0	5.8
2004	121.0	103.1	102.4	103.5	98.1	2.20	94.5	-2.5
2005	108.6	92.6	91.9	93.0	111.4	13.50	105.9	12.0
2006	121.3	103.4	102.6	104.0	104.2	-6.42	106.0	0.0

1. The index shows the average exchange rate of foreign currencies against the Icelandic króna for each period. From September 6, 1995 the trade-weighted basket (goods and services) of 16 currencies replaced the former basket of US dollar (18%), ECU (76%) and Japanese yen (6%). 2. The index shows the average exchange rate of foreign currencies against the Icelandic króna for each period. Since 1995 country weights are based on trade in goods and services but before that on trade in goods only. 3. Based on quarterly information on prices (consumer prices), wages, employment and output in main trading partner countries. 4. Year-on-year.

Table 3 Sales of government securities¹

M.kr.	Treasury bonds			Treasury bills, net	Treasury notes, net	Total
	Sales	Redemptions	Net sales			
1988	4,867	3,413	1,454	-219	-	1,235
1989	5,049	4,170	879	5,171	-	6,050
1990	8,275	1,825	6,450	2,166	75	8,691
1991	5,584	4,433	1,151	298	1,158	2,607
1992	3,661	1,495	2,166	4,645	1,244	8,055
1993	8,200	3,706	4,494	742	3,444	8,680
1994	9,447	6,189	3,258	894	-355	3,797
1995	9,252	9,859	-607	830	1,004	1,227
1996	20,051	27,410	-7,359	391	3,772	-3,197
1997	18,454	15,449	3,005	-7,294	2,932	-1,357
1998	8,957	16,855	-7,898	2,912	-6,320	-11,306
1999	2,975	12,302	-9,327	-5,310	-6,231	-20,868
2000	3,531	13,299	-9,768	-3,928	1,015	-12,681
2001	146	5,690	-5,544	6,033	11,285	11,774
2002	0	18,546	-18,546	1	12,790	-5,755
2003	0	9,453	-9,453	8,500	8,202	7,249
2004	0	11,100	-11,100	-6,000	13,010	-4,090
2005	0	21,963	-21,963	-500	10,099	-12,364
2006	0	15,173	-15,173	-7,750	21,866	-1,057

1. Sales and redemption of Treasury bonds include accrued interest and indexation, but Treasury bills and Treasury notes, net, are at face value.

Table 4 Notes and coin in circulation by denomination

	2002		2003		2004		2005		2006	
	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%
<i>Notes:</i>										
5,000 kr.	5,400,000	65.8	6,105,500	66.9	6,755,000	67.1	7,932,500	69.3	8,787,500	69.5
2,000 kr.	231,000	2.8	233,000	2.6	277,000	2.7	279,000	2.4	350,000	2.8
1,000 kr.	1,778,500	21.7	1,928,500	21.1	2,113,500	21	2,264,000	19.8	2,475,000	19.6
500 kr.	681,750	8.3	735,500	8.1	810,000	8	846,750	7.4	905,000	7.2
100 kr.	96,450	1.2	95,800	1.1	95,600	0.9	95,700	0.8	95,550	0.8
50 kr.	11,500	0.1	11,475	0.1	11,625	0.1	11,800	0.1	11,825	0.1
10 kr.	11,015	0.1	11,010	0.1	11,055	0.1	11,055	0.1	11,050	0.1
Total	8,210,215	100	9,120,785	100	10,073,780	100	11,440,805	100	12,635,925	100.0
<i>Coin:</i>										
100 kr.	691,000	50.1	747,100	51.4	799,300	51.3	924,500	52.5	1,006,180	53.6
50 kr.	308,090	22.3	322,040	22.2	353,440	22.7	388,740	22.1	392,590	20.9
10 kr.	236,660	17.2	245,750	16.9	261,330	16.8	292,130	16.6	314,080	16.7
5 kr.	66,725	4.8	68,780	4.7	72,240	4.6	78,240	4.4	82,480	4.4
1 kr.	66,907	4.9	69,101	4.8	72,218	4.6	77,494	4.4	81,247	4.3
50 aurar	5,160	0.4	.	.	.	.	.	.	.	.
10 aurar	4,173	0.3	.	.	.	.	.	.	.	.
5 aurar	644	0.0	.	.	.	.	.	.	.	.
Total	1,379,358	100.0	1,452,770	100.0	1,558,528	100.0	1,761,104	100.0	1,876,576	100.0

Table 5 Accounts of the Central Bank¹

<i>M.kr. at the end of year</i>	2000	2001	2002	2003	2004	2005	2006
Net foreign exchange reserves	18,736	21,844	20,879	58,150	65,567	67,356	167,975
Domestic items, net ²	13,680	5,972	11,747	-36,450	-27,009	-19,904	-108,457
Claims on Treasury and government institutions, net	-12,119	-31,099	-20,851	-22,185	-17,782	-75,916	-211,036
Claims on other financial institutions	13,074	22,774	8,227	4,193	8,993	11,902	28,547
Claims on deposit money banks	38,978	54,053	69,141	24,038	31,771	77,772	119,863
Other claims	156	105	65	87	84	189	499
Deposits of other financial institutions	-1,504	-2,126	-1,334	-33	-13,681	-145	-131
Other items, net	-24,903	-37,735	-43,500	-42,549	-36,394	-33,706	-46,199
Base money	32,416	27,817	32,626	21,700	38,558	47,452	59,518
Reserves of deposit money banks	25,264	20,410	24,960	13,311	29,415	36,952	48,047
Required reserves ³	21,249	17,678	21,874	3,830	0	0	0
Certificates of deposit	0	0	0	4,501	4,404	2,294	1,777
Cash and liquid reserves	4,015	2,732	3,087	4,980	25,012	34,658	46,269
Notes and coin in circulation	7,152	7,406	7,666	8,390	9,143	10,500	11,471

1. Further breakdown in Table 12. 2. Deposits are marked as negative (-). 3. Separate reserve accounts were merged with deposit accounts after 2003.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 6 Summary of the accounts of deposit money banks¹

<i>M.kr. at end of year</i>	2000	2001	2002	2003	2004	2005	2006 ²
<i>Assets:</i>							
Central Bank position, net	-13,125	-33,493	-44,017	-10,769	-2,409	-40,860	-73,177
Claims on domestic credit institutions	67,184	80,324	81,977	59,508	89,757	105,362	196,396
Domestic credit and marketable securities	686,703	790,772	858,957	1,053,063	1,427,851	2,201,863	2,884,661
Domestic lending	600,169	675,925	694,524	805,376	1,123,510	1,701,806	2,335,031
Treasury bills	1,635	10,591	7,066	14,849	2,440	5,248	2,770
Marketable bonds	63,668	71,108	113,963	157,679	191,875	252,741	265,015
Equities and other variable-income securities	20,557	32,747	43,266	58,717	91,287	223,158	253,464
Leasing contracts	674	401	139	16,442	18,739	18,909	28,380
Shares in affiliated undertakings	5,892	5,185	10,436	38,182	44,731	68,000	76,303
Shares in associated undertakings	8,190	11,577	16,217	8,655	11,159	28,892	16,291
Foreign assets, total	27,383	69,397	129,089	307,745	632,904	1,488,252	3,028,581
Foreign credit and equities	5,323	33,931	59,325	132,842	237,430	723,831	1,281,237
Foreign lending	0	28,393	46,296	113,267	190,455	500,953	812,817
Marketable bonds	2,277	1,408	2,334	3,178	4,554	71,165	227,319
Equities and other variable-income securities	3,046	4,131	10,695	16,397	42,421	151,713	239,114
Shares in affiliated undertakings	1,603	5,501	5,740	24,246	117,499	205,186	329,305
Other foreign assets	20,458	29,965	64,023	150,656	277,974	559,235	1,418,040
Total	782,227	923,762	1,052,659	1,456,384	2,203,993	3,851,509	6,129,057
<i>Liabilities:</i>							
Deposits of residents	291,384	335,497	387,562	456,104	524,689	647,002	726,903
Domestic bond issues	71,704	49,711	72,800	76,372	95,689	146,243	243,074
Other domestic borrowing	23,514	23,270	19,656	36,446	72,359	130,997	188,684
From credit institutions	10,428	16,354	13,500	26,164	42,448	43,837	107,766
From the Housing Financing Fund	0	0	0	0	26,948	82,944	77,855
Foreign liabilities	320,032	403,144	428,266	716,458	1,140,435	2,240,000	3,873,291
Domestic deposits of non-residents	0	0	0	18,839	14,501	52,069	364,379
Securities issues abroad	93,012	195,423	196,611	478,829	896,934	1,842,123	2,814,959
Foreign long-term loans	170,820	173,023	131,474	104,448	86,194	66,843	303,881
Foreign short-term loans	56,200	34,699	100,181	114,340	142,806	278,965	390,073
Capital and subordinated liabilities	70,018	96,159	116,685	157,014	339,081	586,673	955,905
of which subordinated domestic loans	16,081	17,761	24,457	24,304	25,080	30,392	29,100
of which subordinated foreign loans	3,696	14,367	11,749	20,641	71,980	151,125	360,588
Other items, net	-849	11,708	26,678	19,672	36,016	102,603	143,254

1. Kaupthing was licensed to operate as a commercial bank in January 2002 and was thereby reclassified from an investment bank, then merged with Búnaðarbanki in May 2003. Glitnir leasing company merged with Íslandsbanki in May 2003. 2. Preliminary.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 7 Summary of the accounts of the banking system¹

<i>M.kr. at end of year</i>	2000	2001	2002	2003	2004	2005	2006 ²
Foreign assets, net	-275,515	-317,404	-295,953	-350,645	-441,376	-684,319	-686,404
Foreign credit and equities	5,323	33,931	59,239	132,762	237,430	723,831	1,284,133
Foreign assets, short-term, net	39,194	51,809	73,074	233,050	461,629	831,781	1,915,338
External liabilities	-93,012	-195,423	-196,611	-478,829	-896,934	-1,842,123	-2,814,959
Foreign assets unacc. for elsewhere	-227,020	-207,721	-231,655	-237,629	-243,501	-397,808	-1,070,916
Domestic credit	667,256	749,805	803,219	976,520	1,327,859	1,914,880	2,523,616
Treasury and government institutions	5,443	-2,291	12,976	14,452	-1,779	-52,286	-183,410
Municipalities	16,225	18,070	19,194	13,762	13,504	10,788	12,327
Non-bank financial institutions	73,182	81,969	89,709	150,567	192,026	208,125	274,438
Enterprises	408,066	472,031	486,905	592,653	808,165	1,191,840	1,704,921
Households	164,340	180,025	194,435	187,886	305,840	544,418	707,531
Other	0	0	0	17,199	10,103	11,995	7,808
Other financial institutions (deposits = -)	-1,504	-2,126	-1,334	-33	-13,681	-145	-131
Other items, net	509	-18,642	-20,916	-48,775	-198,284	-295,964	-600,129
Broad money and bonds (M4)	370,239	392,614	468,028	540,687	629,521	803,744	1,037,733
Bonds	71,704	49,711	72,800	76,372	95,689	146,243	252,498
Broad money (M3)	298,536	342,904	395,228	464,315	533,832	657,502	785,236
Time savings deposits	166,864	196,723	235,482	275,184	291,753	353,501	423,085
Money and demand savings deposits (M2)	131,672	146,180	159,746	189,131	242,079	304,001	362,151
Demand savings deposits	59,125	75,311	71,990	81,545	102,125	131,216	150,497
Money supply (M1)	72,546	70,869	87,755	107,586	139,953	172,785	211,654
Demand deposits	0	0	0	99,197	130,811	162,285	200,076
Notes and coin in circulation	7,152	7,406	7,666	8,389	9,142	10,500	11,472
Other domestic borrowing	23,514	23,270	19,656	36,446	72,359	130,997	199,480

1. Lending was reclassified among sectors with the introduction of the ÍSAT 95 standard in September 2003. 2. Preliminary.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 8 Liquidity and reserve ratios in %¹

<i>Effective as of:</i>	<i>Reserve requirement ratio</i>	<i>Effective as of:</i>	<i>Reserve requirement ratio</i>
June 1 1979	28.0	January 1 1992	7.0
April 17 1985	18.0	November 1 1992	6.0
March 1 1987	13.0	December 1 1992	5.0
August 1 1988	12.0	November 1 1993	4.0 (2.5) ²
March 1 1989	11.0	May 21 1998	4.0 (1.5) ²
May 1 1990	10.0	March 21 2003	3.0 (1.0) ²
June 1 1990	7.0	December 21 2003	2.0 (0.0) ³
October 31 1991	6.0		

1. Percentage of bank total deposits as of June 1, 1979, of domestic disposable funds as of March 1, 1989 and of all disposable funds as of May 21, 1998. 2. Figure in parentheses refers to the reserve ratio for bond issues and time deposits. 3. Figure in parentheses refers to the reserve ratio for deposits and bond issues with an original maturity of more than two years, such as eligible securities for collateral loans.

Table 9 Main interest rates announced under paragraph 2, Art. 10 and provisional clause III of Act No. 38/2001 on Interest and Price Indexation

General interest rates, rates on damage claims and penalty interest, in % p.a.

	<i>General interest on non-indexed loans</i>	<i>General interest on indexed loans</i>	<i>Interest on damage claims</i>	<i>Penalty interest on claims in</i>								
				<i>ISK</i>	<i>USD</i>	<i>GBP</i>	<i>DKK</i>	<i>NOK</i>	<i>SEK</i>	<i>CHF</i>	<i>JPY</i>	<i>EUR</i>
				January 1, 2006	12.5	4.15	8.3	21.5	7.5	7.5	5.5	5.5
February 1	12.5	4.15	8.3	21.5	7.5	7.5	5.5	5.5	5.5	5.0	5.0	5.5
March 1	12.5	4.15	8.3	21.5	7.5	7.5	5.5	5.5	5.5	5.0	5.0	5.5
April 1	12.5	4.30	8.3	21.5	7.5	7.5	5.5	5.5	5.5	5.0	5.0	5.5
May 1	13.0	4.60	8.7	21.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
June 1 ¹	14.0	4.60	9.3	21.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
July 1	14.0	4.60	9.3	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
August 1	14.5	4.85	9.7	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
September 1	15.0	4.85	10.0	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
October 1	15.5	4.85	10.3	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
November 1	15.5	4.85	10.3	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
December 1	15.5	4.85	10.3	23.5	8.0	7.5	6.0	6.0	5.5	5.0	5.0	5.5
Average 2005	11.0	4.15	7.4	20.3	6.2	7.9	5.5	5.5	5.5	5.0	5.0	5.5
Average 2006	13.9	4.6	9.3	22.5	7.8	7.5	5.8	5.8	5.5	5.0	5.0	5.5

1. Penalty interest on monetary claims denominated in foreign currency, which took effect on June 1, 2006 with Announcement No. 5/2006 on Penalty Interest Rates and Interest Rates on Monetary Claims, remain unchanged until otherwise decided.

Table 10 Selected annual yields of deposit money banks and penalty rates in % p.a.

	<i>Non-indexed loans¹</i>		<i>New (long) indexed securities²</i>		<i>Penalty rates</i>		<i>Credit terms index</i>
	<i>Nominal</i>	<i>Real</i>	<i>Nominal</i>	<i>Real</i>	<i>Nominal</i>	<i>Real</i>	<i>12-month change³</i>
	1990	17.1	9.3	15.7	8.0	26.0	17.6	7.1
1991	18.4	10.0	17.5	9.2	25.0	16.1	7.6
1992	13.5	11.8	11.0	9.3	19.5	17.7	1.6
1993	14.8	11.5	12.4	9.1	17.7	14.3	3.0
1994	10.9	9.5	9.3	7.9	14.2	12.8	1.3
1995	11.9	10.1	10.5	8.7	14.6	12.8	1.6
1996	12.8	10.5	11.1	8.9	15.8	13.5	2.1
1997	13.3	11.1	11.2	9.0	16.3	14.0	2.0
1998	13.2	11.8	10.1	8.8	16.5	15.1	1.3
1999	14.1	8.0	14.7	8.6	17.3	11.1	5.6
2000	17.4	12.7	14.1	9.5	22.0	17.2	4.2
2001	18.8	9.4	19.7	10.2	23.7	13.9	8.6
2002	16.0	13.7	12.3	10.1	21.3	18.9	2.0
2003	12.4	9.4	12.0	9.1	17.3	14.2	2.7
2004	12.6	8.3	10.5	6.3	17.3	12.9	3.9
2005	15.3	10.7	10.3	5.9	20.3	15.5	4.2
2006	18.6	10.9	13.4	6.1	22.5	14.6	6.9

1. Weighted average of DMBs' interest rates. Based on two due dates per year. 2. Weighted average of DMBs' interest rates 3. January to January.

Table 11 Selected Central Bank interest rates

	<i>Bank's current accounts</i>	<i>CB notes, 90-day</i>	<i>Required deposit normal terms</i>	<i>O/N loans, discount rates</i>	<i>Collateral loans, auctions</i>	<i>Certificates of deposit, 7-day</i>
January 12, 2000	4.50	9.30	7.30	10.80	9.00	.
January 18	4.50	9.30	7.30	10.80	9.80	.
January 21	5.30	9.30	8.10	10.80	9.80	.
February 14	5.30	9.60	8.10	11.10	9.80	.
February 15	5.30	9.60	8.10	11.10	10.10	.
February 21	5.60	9.60	8.40	11.10	10.10	.
June 19	5.60	10.10	8.40	11.60	10.60	.
June 21	6.10	10.10	8.90	11.60	10.60	.
November 1	6.90	10.90	9.70	12.40	11.40	.
March 28, 2001	6.70	10.70	9.50	12.40	10.90	.
November 11	6.70	9.60	8.70	12.00	10.10	.
April 1, 2002	6.20	9.10	8.20	12.00	9.60	.
May 1	5.90	8.80	7.90	11.70	9.30	.
May 21	5.70	8.30	7.40	11.20	8.80	.
June 21	5.70	8.00	7.10	10.90	8.50	.
August 21	5.40	7.40	6.70	10.30	7.90	.
September 1	5.10	7.10	6.40	10.00	7.60	.
September 21	4.60	6.60	5.90	9.50	7.10	.
October 21	4.30	6.30	5.60	9.20	6.80	.
November 11	3.80	5.80	5.10	8.70	6.30	.
December 17	3.30	5.30	4.60	8.20	5.80	.
February 28, 2003	2.80	4.80	4.10	7.70	5.30	.
May 11, 2004	3.00	5.00	4.30	7.90	5.50	.
June 8	3.25	5.25	4.50	8.00	5.75	.
July 6	3.75	5.75	5.00	8.25	6.25	.
September 21	4.25	6.25	5.50	8.75	6.75	.
November 1	5.00	6.75	6.00	9.25	7.25	.
December 10	6.25	7.75	7.25	10.25	8.25	.
February 21, 2005	6.75	8.25	7.75	10.75	8.75	.
March 29	7.25	8.50	8.00	10.75	9.00	.
June 7	8.00	9.35	8.75	11.00	9.50	9.35
October 4	8.75	10.10	9.50	11.75	10.25	10.10
December 11	9.00	10.35	9.75	12.00	10.50	10.35
February 1, 2006	9.25	10.25	10.00	12.25	10.75	10.60
April 1	10.00	11.00	10.75	13.00	11.50	11.35
May 21	10.75	11.75	11.50	13.75	12.25	12.10
June 11	11.50	-	12.00	14.25	13.00	12.85
August 21	12.00	-	12.25	14.50	13.50	13.35
September 21	12.50	-	12.75	15.00	14.00	13.85
December 21	12.75	-	13.00	15.25	14.25	14.10
<i>Time-weighted averages</i>						
1998	3.00	7.00	5.50	8.50	7.30	.
1999	3.80	7.80	6.60	9.30	8.30	.
2000	5.90	9.90	8.70	11.40	10.40	.
2001	6.70	10.60	9.40	12.30	10.90	.
2002	5.50	7.80	7.00	10.70	8.40	.
2003	2.80	4.80	4.10	7.70	5.30	.
2004	3.65	5.59	4.88	8.28	6.09	.
2005	7.69	8.85	8.50	11.02	9.35	9.70
2006	11.00	10.63	11.52	13.77	12.50	12.35

Table 12 Balance sheet of the Central Bank of Iceland

M.kr.	End of year					
	2000	2001	2002	2003	2004	2005
Assets						
<i>Foreign assets</i>	45,394	36,823	37,378	58,274	65,709	67,506
Foreign accounts	8,260	5,228	9,509	22,740	23,171	21,049
Gold	1,386	1,752	1,727	1,873	1,707	2,074
Foreign bonds and Treasury bills	22,794	27,423	24,093	31,695	39,058	42,702
IMF reserve position and SDRs	2,059	2,420	2,050	1,966	1,773	1,681
Counterpart to IMF deposits	10,894	0	0	0	0	0
<i>Domestic assets</i>	56,682	79,321	79,248	29,033	40,881	94,789
<i>Deposit money banks</i>	38,978	54,053	69,141	24,038	31,771	77,772
Securities	1	131	105	0	0	0
Collateral loans	36,825	50,020	69,035	24,038	31,771	77,772
Short-term loans	2,152	3,902	0	0	0	0
<i>Other financial institutions</i>	13,074	22,774	8,227	4,193	8,993	11,902
Listed securities	2,865	2,954	3,445	3,223	3,232	1,832
Collateral loans	10,209	18,790	4,782	969	5,762	10,070
Short-term loans	0	1,030	0	0	0	0
<i>Central government</i>	4,475	2,389	1,816	715	32	0
Treasury current account	793	244	0	0	0	0
Listed securities	3,575	2,144	1,816	715	32	0
Listed Treasury bills	106	0	0	0	0	0
<i>Other sectors</i>	156	105	65	87	84	189
Sundry accounts	104	77	25	43	39	151
Securities	52	28	41	44	45	38
<i>Real estate and liquid assets</i>	0	0	0	0	0	4,926
Real estate	0	0	0	0	0	4,527
Other assets	0	0	0	0	0	399
<i>Assets = Liabilities</i>	102,076	116,144	116,627	87,307	106,590	162,294
Liabilities:						
<i>Foreign liabilities</i>	28,477	17,108	18,301	1,858	1,703	1,634
Short-term	15,763	14,979	16,499	124	142	150
Long-term	0	0	0	0	0	0
IMF SDR allocation	1,820	2,130	1,802	1,735	1,561	1,484
IMF deposits	10,894	0	0	0	0	0
<i>Domestic liabilities</i>	51,996	64,709	59,499	40,729	66,282	124,291
<i>Notes and coin</i>	8,672	9,174	9,590	10,583	11,632	13,202
<i>Deposit money banks</i>	23,744	18,643	23,037	6,616	22,519	34,250
Sight deposits	2,495	965	1,163	2,786	22,519	31,956
Required reserves	21,249	17,678	21,874	3,830	0	0
Certificates of deposit	.	.	.	.	.	2,294
<i>Other financial institutions</i>	1,504	2,126	1,334	31	13,681	145
Sight deposits	745	837	75	31	13,681	145
Required reserves	759	1,288	1,259	0	0	0
<i>Central government</i>	16,594	33,488	22,667	22,901	17,815	75,916
Treasury current account	11,339	11,232	8,771	9,689	16,257	33,573
Government institutions	733	1,575	1,977	1,208	519	371
Foreign exchange deposits	4,522	4,544	399	487	1,039	9,113
Tied deposits	0	16,137	11,520	11,517	0	32,859
<i>Other liabilities</i>	1,482	1,279	2,872	597	636	778
Equity	21,602	34,327	38,827	40,217	34,198	36,370
Estimated profit before transfer to Treasury	.	.	.	.	.	.
Capital and reserves	21,602	34,327	38,827	40,217	34,198	36,370

End of month 2006

January	February	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.
68,679	72,360	80,132	66,444	70,659	77,078	74,566	72,801	71,530	71,161	92,670	168,372
22,308	22,828	26,729	8,785	15,681	19,797	20,333	20,899	18,322	17,723	11,022	41,650
2,274	2,332	2,643	3,084	3,003	3,014	2,952	2,761	2,696	2,646	2,830	2,934
42,412	45,448	48,860	52,520	49,976	52,153	49,260	47,219	48,578	48,906	76,897	121,769
1,684	1,752	1,900	2,055	1,999	2,114	2,021	1,923	1,933	1,887	1,920	2,019
0	0	0	0	0	0	0	0	0	0	0	0
84,435	94,571	110,744	100,915	101,734	101,095	121,803	121,961	114,304	138,371	133,354	153,411
67,995	82,953	94,076	86,025	85,135	89,402	109,994	110,081	101,448	118,666	114,115	119,863
0	0	0	0	0	0	0	0	0	0	0	0
67,995	82,953	94,076	86,025	85,135	89,402	109,994	110,081	101,448	118,666	114,115	119,863
0	0	0	0	0	0	0	0	0	0	0	0
16,245	11,414	16,480	14,577	16,410	11,464	11,568	11,639	12,629	19,453	19,020	28,547
1,708	1,675	1,689	1,573	1,583	1,609	1,522	1,515	1,529	1,466	1,465	1,473
14,537	9,739	14,791	13,004	14,827	9,854	10,047	10,124	11,100	17,988	17,555	27,074
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
195	204	188	314	189	229	241	241	227	253	219	143
159	168	153	279	155	133	145	139	127	150	123	48
36	36	35	34	34	95	96	102	99	102	96	95
4,926	4,926	4,926	4,926	4,926	4,926	4,926	4,926	4,926	4,926	4,926	4,859
4,527	4,527	4,527	4,527	4,527	4,527	4,527	4,527	4,527	4,527	4,527	4,479
399	399	399	399	399	399	399	399	399	399	399	380
153,114	166,931	190,876	167,359	172,393	178,173	196,370	194,762	185,833	209,533	226,024	321,784
2,044	1,910	2,092	2,009	1,952	2,061	2,269	2,158	2,171	2,113	24,822	1,874
558	362	412	202	190	197	491	467	467	450	23,130	95
0	0	0	0	0	0	0	0	0	0	0	0
1,487	1,549	1,679	1,807	1,762	1,864	1,778	1,691	1,704	1,664	1,692	1,780
0	0	0	0	0	0	0	0	0	0	0	0
119,403	131,384	149,983	121,677	128,029	130,285	151,111	152,451	143,080	168,326	160,483	271,683
12,429	12,398	12,759	12,979	13,395	13,946	14,523	14,152	13,837	13,654	13,810	14,513
19,936	25,613	43,373	29,893	35,221	30,790	37,885	32,091	21,988	44,298	42,891	44,988
18,135	23,812	41,821	29,091	34,069	29,014	35,305	29,314	20,211	42,523	41,115	43,210
0	0	0	0	0	0	0	0	0	0	0	0
1,801	1,801	1,552	801	1,152	1,776	2,580	2,777	1,777	1,775	1,776	1,777
74	1,686	118	147	184	167	169	178	174	179	172	130
74	1,686	118	147	184	167	169	178	174	179	172	130
0	0	0	0	0	0	0	0	0	0	0	0
86,390	91,075	92,180	76,933	78,507	84,622	97,748	105,185	106,147	109,088	102,510	211,002
42,860	45,625	43,706	40,668	40,851	44,473	57,448	63,400	65,112	68,734	66,020	80,114
531	356	323	452	379	461	642	513	575	685	796	567
10,730	12,576	15,357	3,527	4,688	6,793	7,327	8,599	7,442	7,303	2,976	97,235
32,269	32,518	32,793	32,286	32,589	32,895	32,331	32,673	33,018	32,365	32,718	33,085
574	613	1,553	1,725	722	760	785	846	934	1,107	1,100	1,051
36,593	38,563	43,727	48,600	47,339	50,754	47,916	45,079	45,509	44,020	45,645	48,227
223	2,193	7,357	12,230	10,969	14,384	11,546	8,709	9,139	7,650	9,275	11,857
36,370	36,370	36,370	36,370	36,370	36,370	36,370	36,370	36,370	36,370	36,370	36,370