

The scope of Central Bank foreign currency auctions

Since June 2011, the Central Bank has held regular foreign currency auctions in which investors are invited to use reinvestable foreign currency to buy long-term Treasury bonds. In another auction held the same day, the Central Bank uses the foreign currency from the Treasury bond auctions to buy krónur from non-residents wishing to wind down their ISK positions. Since February 2012, the Bank has also held auctions according to its Investment Programme, under which investors are given the opportunity to use the krónur they acquire in auctions to purchase other assets, subject to a minimum commitment period of five years. The purpose of the auctions is to unwind non-residents' volatile ISK holdings, which could cause substantial instability when the capital controls are lifted.

Nineteen auctions have been held under the Treasury Bond Programme, and investors have imported the equivalent of approximately 56 b.kr. in connection with them. Seventeen auctions have been held under the Investment Programme, generating 153 b.kr. in inflows. About a third of this, or roughly 64 b.kr., has been channelled through the domestic foreign exchange market, as 50% of the amount invested under the Investment Programme must be converted to Icelandic krónur in the domestic market.¹

Economic impact

The foreign currency auctions have had an economic impact in several ways. To some degree, they have generated more investment than would otherwise have taken place, some of it in export sectors. Furthermore, they have supported asset prices, as a portion of the capital entering the country through the Investment Programme has been invested in real estate and stocks. To the extent that investment via the auctions has refinanced corporate debt with more favourable debt instruments or equity, the auctions have also facilitated domestic firms' balance sheet restructuring and lowered their cost of capital. To the extent that the auctions have stimulated demand for Treasury bonds and raised their prices, the Treasury's cost of financing has declined as well. Moreover, the auctions have enhanced the effectiveness of money holdings by transferring krónur from non-residents to residents. Finally, to the extent that they have generated increased foreign currency inflows for investment and asset purchases, the auctions have probably helped shore up the exchange rate.

Quantifying the magnitude of this economic impact is problematic, in part because it is difficult to estimate what would have happened had the auction programme not been introduced. In addition, the auctions have been spread over several years during which there was a slack in the economy and therefore less risk that increased demand would cause a rise in inflation. It is possible to make a rough estimate of the effect of the auctions on effective money holdings and, given certain conditions, on private consumption, investment, house prices, and output growth. The overall effect of the auctions on the economy is more difficult to estimate.

Impact on money holdings

As is stated above, the economic effect of the auctions can be examined in terms of their impact on effective money holdings; that is, the amount of money available to residents for allocation to domestic investment and consumption. Since the Central Bank launched its auction programme, non-residents' deposits with the Bank have contracted by about 85 b.kr. In so doing, they have gone

Box IV-1

The economic impact of Central Bank foreign currency auctions

1. Further discussion of the Central Bank's foreign currency auctions can be found in Box II-2 in *Financial Stability* 2014/1.

from full reserve requirements to 10%, and effective money holdings have increased by about 77 b.kr. as a result – given, that is, that the effectiveness of the share previously held by non-residents was zero, which is probably an underestimation. At the same time, Central Bank deposits held by international payment intermediaries have increased by about 12 b.kr. These deposits are assigned a reserve ratio of 100% unless they are guaranteed by the Depositors' and Investors' Guarantee Fund. Given that about half of them are guaranteed, it can be assumed that these increased deposits have reduced effective money holdings by about 6 b.kr.

All in all, the foreign currency auctions have therefore effectively increased the money stock by 71 b.kr. at most over this period of just under three years. This is commensurate with an increase in M3 of 4½%, or just over 1½% per year. Other things being equal (including the assumption that the monetary policy response would not have been different had the auctions not taken place), this increase in money holdings corresponds to a reduction in market interest rates of nearly ½ a percentage point, or about 0.16 percentage points per year.² It can be assumed that the auctions boosted the domestic economic recovery through the increase in the effective money stock, particularly because they took place at a time where there was some slack in the economy. A rough estimate indicates that house prices and domestic demand increased at most by approximately ½ a percentage point more in 2011-2013 than they would have otherwise, and that GDP growth was stronger by about 0.1 percentage point.

Overall impact

The assessment above merely estimates the auctions' impact on the economy through one channel. There are others, but on the whole, it can be assumed that the impact has been positive. They supported domestic demand when there was a substantial slack in the economy, thereby expediting the economic recovery. They also supported domestic asset prices, which fuelled the recovery even further. In addition, the króna is probably stronger than it would have been without the auctions, and because of this and the slack in the economy at the time they were held, the inflationary effects of the auctions have been negligible hitherto. Now that the spare capacity in the economy is disappearing, however, there is good reason to give closer consideration to the possible effects of the auctions on domestic demand. The Central Bank's forecasts of demand and inflation should incorporate these effects, as well as other key factors that could affect the inflation outlook at any given time.³

Finally, it should be noted that the aim of the auctions is to move volatile krónur from parties that want to convert them to foreign currency immediately and put them into the hands of long-term investors. The auctions therefore promote exchange rate stability in the long run and will thereby support the inflation target and financial stability when the capital controls are lifted.

2. This is because, other things being equal, the public will not want to keep this increased money stock unless the opportunity cost diminishes; that is, unless market interest rates fall. The assessment of the interest rate impact of the increased money holdings is based on the interest elasticity of money demand in the Central Bank's macroeconomic model (QMM).

3. In the same way, it is necessary to consider the potential impact of factors such as the sale of the Central Bank of Iceland Holding Company's assets and claims on liquid assets due to deposits owned by the old banks' estates on effective money holdings and economic activity.