

What is the Central Bank of Iceland managing?

The large increase in repo transactions in recent months between the Central Bank and credit institutions has prompted questions about whether this is not in fact the root of the heavy growth in lending and money supply, and likewise whether the Central Bank does not have grounds for restricting the supply of repurchase agreements in order to curb the growth in money supply and credit institutions' lending capacity. These ideas hinge on the theory that greater central bank base money increases money volume in circulation and thereby causes higher inflation. Admittedly it is not enough to focus only on repos in assessing Central Bank money supply, since other factors impact base money, as explained below.

Theoretically, the Central Bank's interest rates on its facilities are the price it puts on the supply of base money. This means that the Central Bank can choose to manage money supply either by determining volume or interest rates in its monetary actions, but not both.

Most central banks in industrial countries have opted to manage interest rates on their facilities rather than supply of base money.

There are several reasons for this preference for managing interest rates in monetary actions. Firstly, quantitative management of base money leads to greater fluctuations in money market interest rates, which can create uncertainty about the real intent of the Bank's monetary stance. Interest rate management is more transparent and is also less disruptive. Secondly, quantitative restrictions on credit supply from the Central Bank can exacerbate liquidity troubles among individual credit institutions and produce systemic problems. This happens when the Central Bank refuses to lend funds to a credit institution on account of monetarist viewpoints about base money supply. Finally, central banks which have attempted base

money management have discovered that there are technical problems to targeting this variable in an open economy with free capital flows. Applying base money management under such circumstances can generate currency fluctuations, since the Central Bank is unable to intervene to influence exchange rate developments.

The Central Bank does not apply money supply management, and interest rates are its main instrument. Until relatively recently the Bank controlled all interest rates in Iceland on the basis of legal provisions allowing it to determine minimum interest rates for deposits and maximum rates for lending. After deregulation of interest rates in Iceland over the period 1986-1987 the Central Bank has continued to prioritise interest rate management. Initially its instrument was the yield on treasury bonds in the secondary market, but the money market has now evolved into the forum for its interest rate action. The arrangement has proved an effective one. The Central Bank policy rate, which is now the yield on repurchase agreements with credit institutions, creates a marginal short-term capital cost for credit institutions, and changes in Bank policy rates have a quick impact on other money market and credit market interest rates.

It should also be pointed out that Central Bank repos are not the only factor possibly affecting base money, and quantitative controls on such transactions by themselves would not set out a specific pattern for the Bank's base money to develop. Thus Central Bank base money grew by only 0.9 billion kr. in 1998 but repo trading volume by 16.3 billion kr. at the same time. The reason was a substantial improvement in the treasury's position with the Central Bank. Similarly, foreign currency trading by the Central Bank can impact base money.