

#### Box 4 Central Bank interventions in the foreign exchange market in the build up to and wake of the changed monetary policy framework in March 2001

When the Central Bank intervened in the foreign exchange market on March 23, 2001 rumours had begun to circulate that an announcement of a change in its monetary policy framework was pending at its annual meeting three days later. It was said that the Bank planned to move onto an inflation target and float the króna, which would probably cause greater exchange rate volatility, in the short term at least. Last but not least, it would remove the investors' safety net, i.e. the Central Bank's obligation to defend the exchange rate band. Fuelling this speculation was a remark by the Prime Minister that major news was expected from the meeting (quoted in *Morgunbladid* on March 27, 2001). Great uncertainty broke out in the foreign exchange market and the króna came under heavy strain to sell. The Central Bank intervened in an attempt to halt the depreciation, but with little effect. In spite of sizeable interventions the foreign exchange rate index rose over these days and was higher at the close of the day than when the market opened.

The Central Bank's annual meeting was held on March 27, 2001 (after the closure of the foreign exchange market) where it announced that it would introduce inflation targeting and float the króna. When the market closed on March 27, 2001 the foreign exchange rate index stood at 125.1 points, while the upper band was 125.4. Thus the Central Bank had succeeded in defending the band, although it was a close call and it was uncertain whether the Bank could have managed to do so for much longer. Subsequently, the króna continued to weaken. Turnover was heavy in the foreign exchange market and participants tried to put pressure on the Central Bank to intervene. Difficult days followed in the market, and May 2, 2001 is probably the most memorable. The participants' positions had worsened and the market was very one-sided. Under strong pressure, the króna fell by 5.8% over the day. Turnover in the foreign exchange market amounted to more than 36 b.kr., the highest volume ever in a single day.

The subsequent period was very one-sided too, and on June 21, 2001 the Central Bank decided to re-enter

the foreign exchange market for the first time after the reform of the monetary policy framework. By then the foreign exchange rate index had risen above 145 points and the króna had fallen by more than 13% since the Bank moved onto an inflation target. As well as entering the market, the Central Bank had negotiated with market participants on the payment of a temporary commission for market making (which was discontinued at the end of 2002). At the same time it was announced that the government had made a new 25 b.kr. foreign loan which would be used to strengthen the Central Bank's foreign reserve. This calmed the market down and the index went below 135 points in August. Nonetheless, it rose again and passed 141 on September 20. The Central Bank's next intervention was at the end of September, when part of the foreign loan that had been promised in June was disbursed. It was hoped that the króna could be strengthened and the trend possibly even reversed. From September 28 to October 12, 2001 the Central Bank sold US dollars to market participants for the equivalent of almost 10 b.kr.

Following a short-lived strengthening in the wake of the intervention, the króna continued to weaken until November 28 when the highest index value for the year was recorded, or 151.2. After that the trend reversed and by the end of the year the króna had strengthened by 6½% since November 28. News on more favourable foreign trade and inflation developments were published at the same time. In December labour market participants also announced that a wage agreement review scheduled for February 2002 would be postponed until May, serving to reduce the likelihood of excessive wage rises which could have weakened the króna and caused mounting inflationary pressure.

It can therefore be said that the exchange rate depreciation trend was not reversed until domestic economic developments improved, which caused market participants' views and expectations to become more favourable for the króna.