Box 1 Liquidity forecast model

Using a fairly simple model of financial flows, the Central Bank of Iceland has evaluated its need for measures to curb liquidity overflows. The model both takes into account Central Bank operations such as repos, reserve requirements, currency purchases and changes in the volume of notes and coin in circulation, and describes the effects of Treasury actions on liquidity formation. All available information is used and forecasts are made for the period two weeks ahead. Various problems arise when such forecasts are made, e.g. the Bank cannot estimate the exact requirement for reserve funds as it cannot foresee how credit institutions will use the leeway that the system offers. Since the Central Bank is unable to foresee repos in the next week, it assumes an unchanged position then. To estimate the effects of the Treasury, the Bank uses historical data and monitors its bond auctions and redemptions. Table 1 shows the variables in the model.

To evaluate the requirement for Certificates of Deposit (CDs), the Bank takes the results of repo auctions into account and calculates how much to issue to even out the average two-week difference. It is known that the model is imperfect and both its assumptions and predictions themselves need to be evaluated, but along with other information it can provide the Bank and market participants with valuable indications about the liquidity position.

Table 1 Liquidity forecast model

	Liquidity forecast model	*Notes*
+	Base requirement	Negative when requirement
+	Reserve requirements (average)	Negative when unfilled reserve requirements
–	Treasury	Always positive (based on forecast)
+	Transactions between CB and Treasury	E.g. CB sells currency to Treasury
+	Estimated CB currency purchases	CB purchases in the interbank market
+	Notes and coin	Daily figures (based on forecast)
=	Estimated requirement or surplus	Estimate prior to CB operations
+	Repos (outstanding stock)	Outstanding repo stock after auction
=	Difference	Difference per day
–	CDs issued	Daily total
=	Difference	Daily total of differences
=	Averaged difference	Average of differences over the next 14 days

revoking them. Under the previous settlements this would only have cancelled basic wage rises, but now the second pay-scale change and the second increase in employer pension fund contribution will not take effect either.

In connection with the signing of these agreements, the government made a commitment to back a 0.45% reduction in national insurance contributions in 2007, provided that SA agrees to raise contributions to mandatory funds from 7% to 8% at the same time. The government will also support a 3% increase in unemployment benefit over and above rises in the minimum wage guarantee over the period. Finally, the government will ensure that contributions continue to be made into a fund for job training until it is taken over by employers when the settlements expire. This measure will cost the Treasury 2½ b.kr.