

Foreign exchange market, exchange rate developments, and foreign exchange reserves 2016

Foreign currency inflows were strong in 2016, foreign exchange market turnover grew, and the Central Bank's foreign exchange reserves increased significantly. Turnover in the interbank foreign exchange market increased by 42% year-on-year, and the Bank's share was 55%. The Bank bought foreign currency from market makers in the amount of 386 b.kr. during the year, thereby mitigating the appreciation of the króna. In spite of the Bank's purchases, the króna appreciated by 18.4% during the year. The foreign exchange reserves increased by 163 b.kr., primarily because of net foreign currency purchases by the Central Bank, and amounted to 815 b.kr. at the year-end.

Foreign exchange market

Interbank foreign exchange market turnover totalled 702 b.kr. in 2016, some 42% more than in the prior year. The Bank's share of turnover was 55%, broadly the same as in 2015. All of the Bank's transactions during the year were of the same type; i.e., the Bank bought currency from market makers in the interbank market. The Bank's purchases totalled 386 b.kr. (EUR 2,891 m), which is equivalent to 16% of estimated GDP for the year. The Bank's total foreign currency purchases during the year were 42% more than in 2015.

The Central Bank bought EUR 6 m per week in regular, preannounced transactions with market makers. These transactions accounted for 11% of the Bank's total purchases for the year.

A surplus on external trade, a declining foreign exchange position in the banking system, and several large transfers of capital to the country by private entities caused sustained upward pressure on the exchange rate in 2016. In the first half of the year, there were also some foreign currency inflows due to new investment in Treasury bonds. These flows halted when the new capital flow management measure was introduced in June, as can be seen in Chart 1 on capital flows due to new investment. Balance of payments figures for Q3/2016 show that the

appreciation of the króna in that period was due largely to the trade surplus and not to capital transactions.

Early in the year, the Bank bought foreign currency with the primary objective of bringing the foreign exchange reserves to the desired size during the prelude to general capital account liberalisation. After that objective was achieved, it became more important to mitigate fluctuations in the exchange rate and to prevent over-appreciation before important steps in the liberalisation process were taken.

As can be seen in Chart 2, which illustrates the Central Bank's monthly transactions in the interbank market, the Bank bought more foreign currency in each month of 2016 than in the prior year, apart from August, September, and December. The Bank bought the most in October (49.6 b.kr.) and the least in December (17.8 b.kr.). In June, July, and August, the Central Bank's foreign currency purchases totalled approximately 120 b.kr. In the final weeks of the year, foreign currency inflows subsided, and in December the Bank bought less currency than in the same month of 2015, and the exchange rate fell slightly.

Exchange rate developments

In spite of substantial foreign currency purchases by the Central Bank, the exchange rate of the króna¹ appreciated by 18.4% in 2016, as can be seen in the chart showing the exchange rate, although it fell slightly towards the end of the year. The Bank's currency purchases prevented an even greater appreciation and mitigated short-term exchange rate volatility. The króna appreciated most in October (3.5%) and depreciated most in April (0.6%). The spread between the highest and lowest quoted exchange rate for the year was about 20%. It was highest in December (trade-weighted index 159.99) and lowest in January (trade-weighted index 192.01). Annualised daily volatility was about 3.8% in 2016, as opposed to 3.3% in 2015.

Foreign exchange reserves

The Central Bank's foreign exchange reserves increased by 163 b.kr. (USD 1.4 billion at the year-end exchange rate) in 2016, totalling 815 b.kr. (USD 7.2 million) by the year-end. At the end of the year, the reserves equalled 34% of GDP and 49% of broad money (M3), and they covered eleven months' worth of goods and services imports.

The Central Bank's net foreign currency purchases totalled 386 b.kr. (EUR 2.9 bn, or USD 3.4 bn) in 2016 and accounted for most of the increase in the reserves during the year. The Central Bank of Iceland Asset Management Company and the Treasury's foreign-denominated

¹ In terms of the narrow trade basket.

recoveries of claims against the failed banks' estates increased the reserves by 27 b.kr., and the sale of Arion Bank's foreign currency loan to the estate amounted to 56 b.kr. Arion Bank's retirement of a bond owned by the Treasury increased the reserves by 9.1 b.kr. The Treasury's purchases of foreign currency in connection with stability contributions totalled 9.4 b.kr., and the sale of bonds issued by Glitnir, Kaupthing, and LBI totalled 30 b.kr.

The most important factors reducing the size of the reserves during the year were the Central Bank's foreign exchange transactions with the failed banks' estates, in the amount of 75 b.kr., and the maturities of Treasury foreign loans, in the combined amount of 64 b.kr. Foreign currency auctions and foreign exchange transactions in connection with offshore krónur entailed FX outflows of 65 b.kr. In addition, the Treasury paid the Pension Fund for State Employees 14 b.kr. in foreign currency.

Exchange rate movements and changes in the market value of bonds reduced the krónur value of the reserves by 121 b.kr.

At the end of 2016, the foreign exchange reserves net of the Central Bank and the Treasury's foreign-denominated debt were positive by 592 b.kr., up from 304 b.kr. at the end of 2015, as the table shows. The reserves thus calculated grew by 288 b.kr. in 2016. The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 610 b.kr. at year-end 2016, as opposed to 358 b.kr. at the end of 2015.

Further information can be obtained from Már Guðmundsson, Governor of the Central Bank of Iceland, at tel: +354 569-9600.

Table 1. Foreign exchange market, exchange rate, and foreign exchange reserves

		2014	2015	2016
Exchange rate (- depreciation/+appreciation)	%	1.7%	7.9%	18.5%
Exchange rate volatility	%	3.2%	3.1%	3.8%
FX market turnover	b.kr.	266.4	492.7	701.7
— FX market turnover, Central Bank	%	42.9%	55.3%	55.1%
FX market purchases, Central Bank	m.kr.	112,764	272,412	386,242
FX market sales, Central Bank	m.kr.	1,396	0	0
Net purchases, Central Bank	m.kr.	111,368	272,412	386,242
Foreign exchange reserves, in US dollars	USD m	4,178	5,042	7,210
Foreign exchange reserves, in b.kr.	b.kr.	530	653	815
FX reserves financed domestically**	b.kr.	20	304	592
Central Bank foreign exchange balance***	b.kr.	138	358	610
Foreign exchange reserves, as % of GDP	%	26	30	34*
Foreign exchange reserves, equivalent months of imports****		7	9	11

* Based on Central Bank of Iceland year-2016 GDP forecast.

** Foreign exchange reserves net of Central Bank and Treasury foreign debt

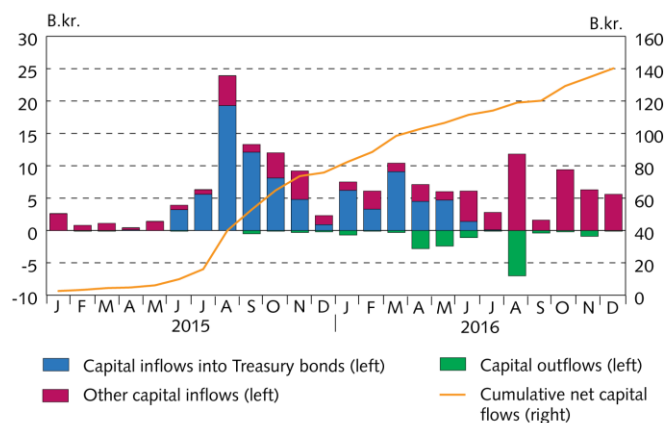
***Difference between assets and liabilities in foreign currency

****Five-year average

Chart 1

Capital flows due to registered new investments

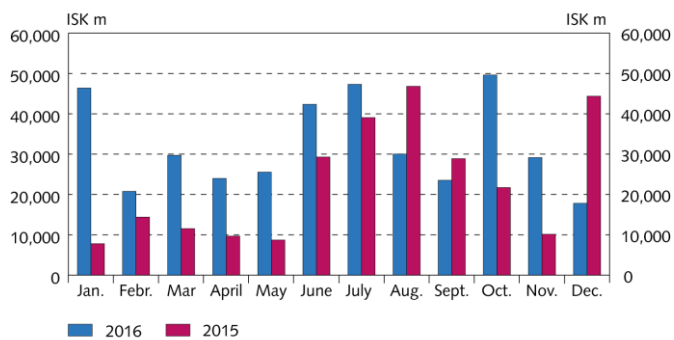
January 2015 - December 2016



Source: Central Bank of Iceland.

Chart 2

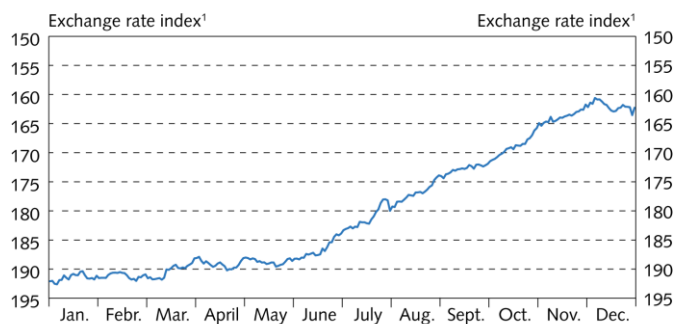
CBI's monthly interbank market FX purchases



Source: Central Bank of Iceland.

Chart 3

Exchange rate of the króna



1. Narrow trade basket. The chart shows a rising exchange rate for most of the year.

Source: Central Bank of Iceland.