

Foreign exchange market, exchange rate developments, and international reserves 2018

The króna depreciated by 6.4% in 2018, and turnover in the interbank foreign currency market contracted sharply year-on-year. In H2/2018, the Central Bank sold currency in the interbank market three times, with the aim of mitigating fluctuations in the exchange rate of the króna. The Bank's net foreign currency sales in the market totalled 2.9 b.kr. during the year. The exchange rate was relatively stable in the first eight months of the year, and turnover was limited. The market grew turbulent in the autumn, partly because of uncertainty in the air transport sector, and the currency weakened. In December, the exchange rate rose again after a relatively sharp decline since the beginning of September. The Central Bank then bought currency in the interbank market for the first time in more than a year. At the beginning of November, an amendment was made to the special reserve ratio provided for in the Rules on Special Reserve Requirements for New Foreign Currency Inflows. The ratio was lowered from 40% to 20%. The international reserves amounted to 736 b.kr. at the year-end, or 26% of GDP.

Exchange rate developments and foreign exchange market transactions

The króna depreciated by 6.4% from the beginning to the end of 2018. It depreciated by 6.1% against the euro and by 10.2% against the US dollar. The króna bottomed out in November but was strongest in March. The spread between the highest and lowest listed exchange rate for the year was about 18.9%. Chart 3 shows intramonth exchange rate movements. The change was greatest in October, at 6.9%, and least in January, at 0.5%.

Table 2 shows key figures on fluctuations in the króna in 2018 and, for comparison purposes, corresponding figures for several advanced and small countries' currencies. The króna does not stand out in terms of volatility (measured in terms of the standard deviation of daily changes), but the spread between the highest and lowest exchange rates in 2018 was widest in Iceland. There was little difference, however, between Iceland, Australia, and New Zealand. The difference between the highest and the lowest rate could change considerably from one year to another.

In the first eight months of 2018, foreign exchange market turnover was limited, and the exchange rate of the króna was stable. At the beginning of September, the exchange rate began to fall and daily fluctuations to

increase. The depreciation of the króna during the autumn was due in part to uncertainty in the air transport sector. Furthermore, the macroeconomic factors that had supported the exchange rate had begun to weaken to a degree.¹ After the proposed merger of Icelandair and WOW Air was announced, the market calmed down and daily fluctuations subsided. At the end of November, it was announced that the proposed merger would not take place, and soon thereafter it was announced that a foreign investor had been in discussions with WOW.

At the beginning of November, amendments were made to the special reserve ratio provided for in the Rules on Special Reserve Requirements for New Foreign Currency Inflows.² Conditions had developed that enabled the reduction of the special reserve ratio from 40% to 20%, owing to the decline in the exchange rate and the narrowing of the interest rate differential with abroad. In early December, the Government agreed to present to Parliament a bill of legislation from the Minister of Finance and Economic Affairs, amending the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016, and the Foreign Exchange Act, no. 87/1992.³ It is expected that the bill will be discussed in Parliament after the next legislative session begins later this month.

All of the Bank's transactions in the interbank foreign exchange market took place in the second half of the year. The Bank's first transaction of 2018 took place in September, the first intervention since November 2017. The Bank traded in the market on four days during the year, but in varying amounts on each day. The Bank sold currency three times and bought it once. After a relatively sharp increase in the exchange rate in December, the Bank bought foreign currency. It was the Bank's first foreign currency purchase in the market in over a year.

Turnover in the interbank foreign exchange market totalled 187.2 b.kr. (1,445 million euros) in 2018, a contraction of 54% since 2017. The Bank's turnover in the interbank market totalled 3.7 b.kr. (27 million euros), or 79.4 b.kr. less than in 2017. The Bank sold 3.3 b.kr. (24

¹ See *Monetary Bulletin* 2018/4:

<https://www.cb.is/library/Skraarsafn---EN/Monetary-Bulletin/2018/November-2018/Monetary%20Bulletin%202018-4.pdf>

² Press release: Amendments to Rules on Special Reserve Requirements for New Foreign Currency Inflows: <https://www.cb.is/publications/news/news/2018/11/02/Amended-Rules-on-Special-Reserve-Requirements-for-New-Foreign-Currency-Inflows/>

³ Press release: Amending bill of legislation – liberalisation of capital controls on offshore króna owners and special reserve requirements on capital inflows:

<https://www.cb.is/publications/news/news/2018/12/07/Amending-bill-of-legislation-liberalisation-of-capital-controls-on-offshore-krona-holders-and-reserve-requirement-on-capital-inflows/>

million euros) but bought 0.4 b.kr. (3 million euros). The last time the Bank was a net seller in the interbank market was in 2009.

International reserves

The Bank's international reserves increased by roughly 49 b.kr. in 2018 and amounted to 736 b.kr. at year-end. In US dollar terms, however, they contracted by 0.3 billion dollars, to a total of 6.3 billion dollars at the year-end. At that time, the reserves totalled 26% of GDP and 38% of broad money holdings (M3), and they covered nine months' worth of goods and services imports.

The Bank's net foreign currency sales in the interbank market totalled 2.9 b.kr., and interest payments on central government foreign loans totalled 2.1 b.kr. Other foreign exchange transactions totalled 14.3 b.kr. Exchange rate movements increased the reserves by 60.3 b.kr. in krónur terms, and investment gains increased them by 5.1 b.kr.

At the end of 2018, the international reserves net of the Central Bank and central government's foreign-denominated debt were positive by 588 b.kr. as opposed to 587 b.kr. at the end of 2017. The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 627 b.kr. at year-end 2018, as opposed to 587 b.kr. at the end of 2017.

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 international reserves

		2016	2017	2018
Exchange rate (-depreciation/+appreciation)	%	18.5%	-0.7%	-6.4%
Exchange rate volatility*	%	4%	13%	9%
FX market turnover	m.kr.	701,670	407,385	187,180
Central Bank turnover	%	55.1%	20.4%	2.0%
FX market purchases, Central Bank	m.kr.	386,242	76,672	401
FX market sales, Central Bank	m.kr.	0	6,419	3,279
Net purchases, Central Bank	m.kr.	386,242	70,253	-2,878
	USD			
Foreign exchange reserves, in US dollars	millions	7,231	6,575	6,324
Foreign exchange reserves, in b.kr.	b.kr.	815.8	686.6	735.7
FX reserves financed domestically**	b.kr.	590	587	588
Central Bank foreign exchange balance***	b.kr.	608.7	587.3	627
Foreign exchange reserves, as % of GDP****	%	33%	26%	26%
Foreign exchange reserves, equivalent months of imports*****		10	8	9

*Standard deviation of daily exchange rate movements, annualised

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

***Difference between assets and liabilities in foreign currency

****Based on Central Bank of Iceland year-2018 GDP forecast

*****Five-year average

Table 2. Exchange rate developments in 2018, selected currencies

	ISK	USD	NOK	GBP	CHF	SEK	AUD	CAD	NZD
Standard deviation of daily changes (%)	0.5	0.5	0.4	0.4	0,3	0.4	0.5	0.5	0.5
Change during the year (%)	-6.1	4.6	-1.2	-1.2	3.6	-3.9	-9.7	-7.9	-5.7
Spread between highest and lowest exchange rate (%)	17.3	11.2	6.1	5.1	6.9	9.5	15.3	10.8	15.3

ISK (Icelandic króna); USD (US dollar); NOK (Norwegian krone); GBP (British pound); CHF (Swiss franc); SEK (Swedish krona); AUD (Australian dollar); CAD (Canadian dollar); NZD (New Zealand dollar)

*The exchange rate of the Canadian, Australian, and New Zealand dollars is calculated vis-à-vis the US dollar. Other exchange rates are calculated vis-à-vis the euro. Calculations are based on data from the Central Bank of Iceland and Reuters.

Chart 1

Exchange rate of the króna 2018

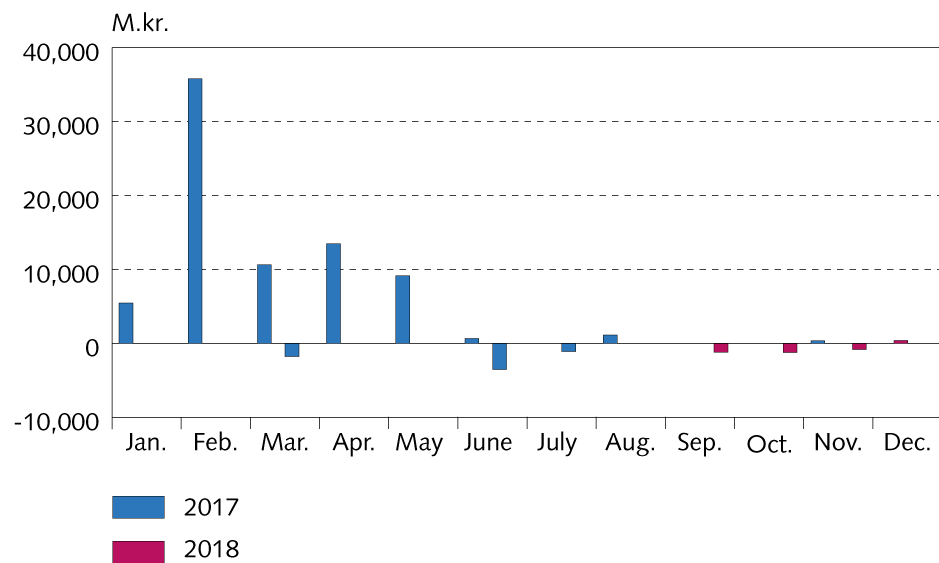


Narrow trade basket. A rise in the line indicates an appreciation, and a decline indicates a depreciation.

Source: Central Bank of Iceland.

Chart 2

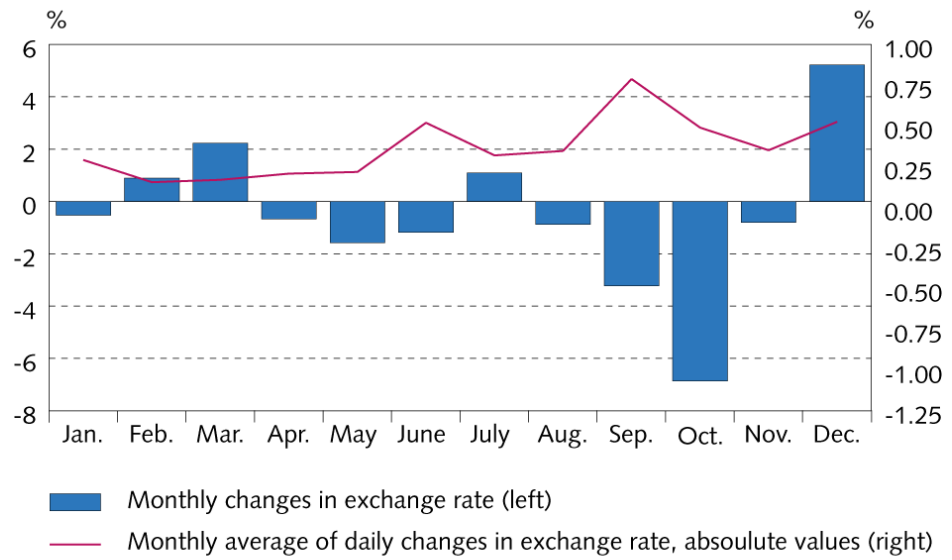
Central Bank foreign exchange market purchases and sales 2017-2018



Source: Central Bank of Iceland.

Chart 3

Monthly changes in exchange rate 2018



Source: Central Bank of Iceland.