

Foreign exchange market, exchange rate developments, and international reserves 2017

The króna depreciated by 0.7% in 2017, and interbank market turnover contracted by 42% year-on-year. The Central Bank intervened in the foreign exchange market, primarily in the first half of the year, thereby mitigating exchange rate volatility. The Bank's net foreign currency purchases in the interbank market totalled 70.3 b.kr. Important steps were taken in the capital account liberalisation process during the year, and general exemptions from most restrictions on movement of capital were granted with regulatory amendments in March. Fluctuations in the exchange rate of the króna were much greater than in the years beforehand, owing to the liberalisation of the capital controls and differing expectations concerning exchange rate developments early in the year. Exchange rate volatility receded markedly during the autumn. The international reserves contracted during the year following the retirement of Treasury foreign debt and the purchase of offshore króna assets. They remain large in historical context, however, measuring 27% of GDP at the end of 2017.

Exchange rate developments and foreign exchange market transactions

The króna depreciated by 0.7% from the beginning to the end of 2017. It fell by 4.7% against the euro but appreciated by 8% against the US dollar. The exchange rate was lowest in January and highest in June. The highest listed exchange rate index value for the year was 16% above the lowest. Chart 3 shows the change in the exchange rate within each month of the year: it was largest in February, at 9.3%, and smallest in September, at 0.5%.

Early in the year, there was considerable uncertainty about the impact of the planned capital account liberalisation and the fishermen's strike on the exchange rate of the króna. At the beginning of the year, the second step of the third phase of the authorities' liberalisation strategy from June 2015 was implemented, when permissible maximum capital

transfer amounts were increased significantly.¹ In February, the Central Bank pledged to grant exemptions for derivatives trading for permanent hedging purposes,² and in March most of the remaining capital controls were lifted with a regulatory amendment³.

Short-term exchange rate volatility increased with the liberalisation of the controls, in part because it appeared initially that market agents were highly uncertain and not at all in agreement about how the exchange rate would respond. The Central Bank also scaled down its foreign exchange market intervention in the spring, as the Monetary Policy Committee was of the view that the international reserves were ample and the exchange rate reflected underlying fundamentals. The Committee reiterated that the Bank would continue to intervene in the market as needed, and in order to mitigate exchange rate volatility.⁴ In the autumn, short-term volatility subsided significantly, and as the year progressed there was less cause for intervention.

Turnover in the interbank foreign exchange market totalled 407 b.kr. in 2017, after contracting by 42% since 2016. Central Bank transactions accounted for 20% of total turnover in 2017, as opposed to 55% in 2016. The Bank's net foreign currency purchases in the interbank market totalled 70.3 b.kr. (603 million euros), about 316 b.kr. less than in 2016. In May, the Central Bank discontinued its regular purchase programme, under which it had bought 6 million euros per week in the market.⁵

The Bank's interbank market purchases of foreign currency took place almost entirely in the first half of the year. They were concentrated largely in Q1, when the Bank bought currency for the equivalent of 51.9 b.kr. (444 million euros) and intervened by selling currency for the equivalent of 1.8 b.kr. (15 million euros). The Bank purchased the most in February, the equivalent of 35.8 b.kr. (306 million euros). Shortly after the liberalisation of capital controls was announced in March, the Bank intervened in the market by selling currency, which it had not done since November 2014. The Bank sold currency again a few times in June and July in response to sharp exchange rate movements. As can be seen in Chart 2, the Central Bank did not

¹ Press release: [Amendments to the Rules on Foreign Exchange, etc.](#), 30 December 2016.

² Press release: [Exemptions for derivatives trading for hedging purposes](#), 24 February 2017.

³ Press release: [New Rules on Foreign Exchange](#), 12 March 2017.

⁴ See the [Minutes of the Monetary Policy Meeting on 6 and 7 February 2017](#) and the [Statement of the Committee on 17 May 2017](#).

⁵ Press release: [Central Bank suspends regular foreign currency purchases](#), 18 May 2017.

intervene at all in the foreign exchange market in September, October, and December. The last time before then that a full month had passed without any Central Bank activity in the market was in 2013.

International reserves

The Central Bank's international reserves shrank by 130 b.kr. in 2017, to 686 b.kr. (USD 6.6 billion) at the year-end, the equivalent of 27% of GDP, 39% of broad money holdings (M3), and eight months' worth of goods and services imports.

The main reason the reserves contracted during the year was the Treasury's 116 b.kr. buyback of a US dollar bond and 49 b.kr. buyback of a eurobond. Foreign exchange transactions in connection with the Bank's purchase of offshore króna assets during the period from March through June reduced the reserves by 99 b.kr.

To offset the above-mentioned 49 b.kr. buyback, the Treasury issued a eurobond that expanded the reserves by 62 b.kr. Other transactions that increased the reserves were the Central Bank's net foreign currency purchases in the interbank market, in the amount of 70 b.kr., and other foreign exchange transactions totalling 33 b.kr.

Exchange rate movements reduced the reserves by 13 b.kr. in krónur terms, and interest and market value changes increased them by 3 b.kr.

At the end of 2017, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 568 b.kr. as opposed to 592 b.kr. at the end of 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 587 b.kr. at year-end 2017, as opposed to 609 b.kr. at the end of 2016.

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

		2015	2016	2017
Exchange rate (- depreciation/+appreciation)	%	7.9	18.5	-0.7
Exchange rate volatility*	%	3.1	3.8	12.8
FX Market turnover	b.kr.	492.7	701.7	407.4
- FX market turnover, Central Bank	b.kr.	0.6	0.6	0.2
FX Market purchases, Central Bank	b.kr.	272.4	386.2	76.7
FX market sales, Central Bank	b.kr.	0	0	6,4
Net purchases, Central Bank	m.kr.	272	386	70
International reserves	m.USD	5,037	7,231	6,571
International reserves	b.kr.	652.8	815.8	686.1
International reserves financed domestically**	b.kr.	304	592	568
Central Bank foreign currency balance***	b.kr.	357.9	608.7	587.3
International reserves, as % of GDP****	%	29	33	27
International reserves, equivalent months of Imports*****		9	10	8

*Annualized standard deviation of daily exchange rate changes.

**Difference between assets and liabilities in foreign currency.

***International reserves net of Central Bank and Treasury foreign debt.

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

*****Five year average.

Chart 1

Exchange rate of the króna

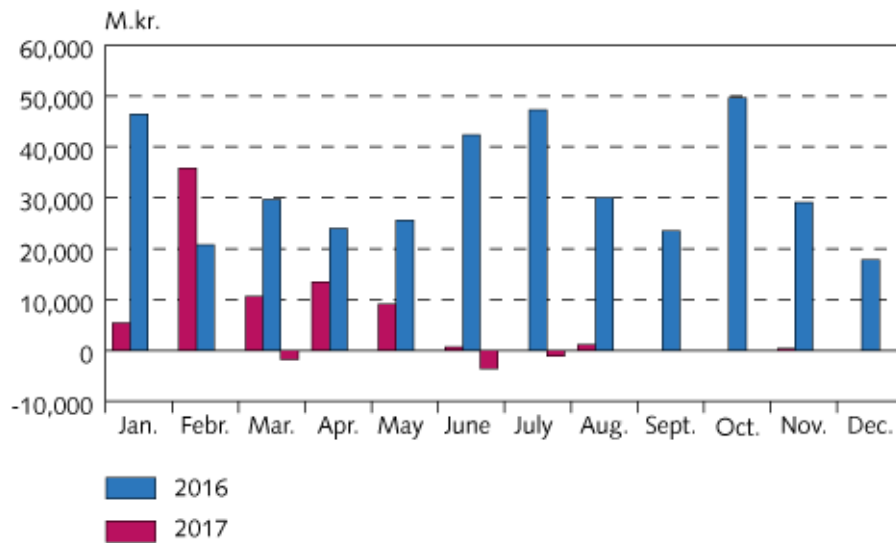


Narrow trade basket. A rise in the line indicates an appreciation, and a decline indicates a depreciation.

Source: Central Bank of Iceland.

Chart 2

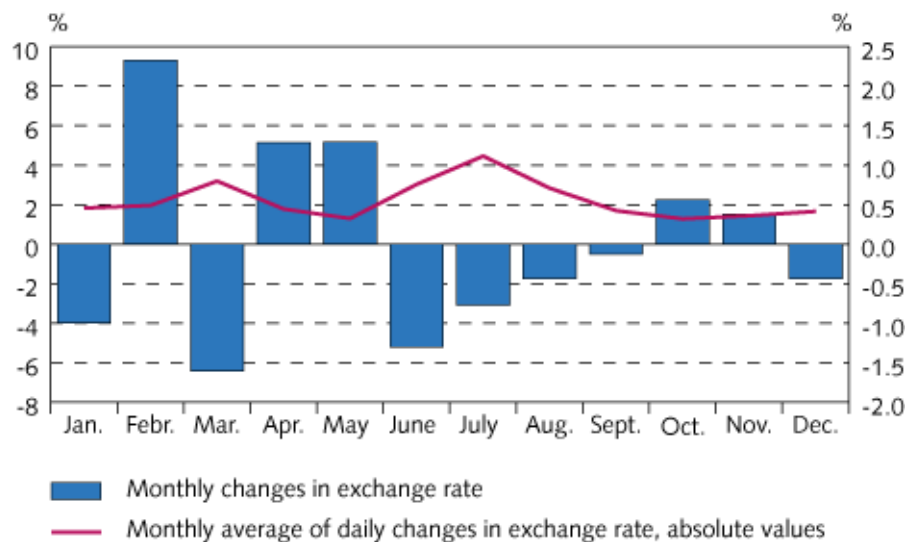
Central Bank foreign exchange market purchases and sales 2016-2017



Source: Central Bank of Iceland

Chart 3

Monthly changes in exchange rate 2017



Source: Central Bank of Iceland.