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## Foreign exchange market, exchange rate developments, and international reserves 2020

*The króna depreciated by 10.4% in 2020, and turnover in the interbank foreign currency market increased by 124% year-on-year. The domestic foreign currency market was strongly affected by the COVID-19 pandemic, and the Central Bank conducted large-scale trades in the market to mitigate volatility and improve price formation. The Bank's net foreign currency sales in the market totalled 132.7 b.kr. during the year. The exchange rate fell most in March, after the first cases of COVID-19 were diagnosed in Iceland, but it was more stable in the months thereafter. The pension funds' decision to suspend currency purchases for foreign investment played an important role in maintaining exchange rate stability. The Bank also conducted foreign currency trades due to large capital transactions by foreign investors in connection with sales of domestic securities and offshore króna. At the year-end, the Bank's international reserves totalled 816.7 b.kr., or 30% of GDP.*

The exchange rate of the króna fluctuated significantly in 2020. After holding relatively stable in the early weeks of the year, the króna began to depreciate at the end of February, after the first COVID-19 cases were diagnosed in Iceland and it became clear that export sectors would suffer a severe shock. The exchange rate bottomed out in September, but the most pronounced change in a single month occurred in March, when it fell by 8.5%. In terms of the trade-weighted exchange rate index (TWI), the króna depreciated by 10.4% over the year as a whole. The highest index measure for the year was 18.5% higher than the lowest one.

Pandemic-related shocks to tourism and other export sectors and large-scale capital transactions by foreign investors in connection with sales of domestic securities and offshore króna strongly affected the exchange rate during the year. The Bank sold foreign currency in the interbank foreign exchange market as it deemed necessary in order to mitigate volatility, and to deepen the market and improve price formation. In all, the Bank sold currency for 144.4 b.kr. (902 million euros) and bought currency for 11.7 b.kr. (77 million euros). Its net foreign currency sales

came to 132.7 b.kr. (825 million euros). After consultation with the Central Bank, the pension funds refrained from purchasing foreign currency for foreign investments for a six-month period from 17 March until 17 September. This hiatus played an important role in maintaining stability in the foreign exchange market.

The Bank's sales of foreign currency during the year fell into three categories: it intervened in the market, selling currency when it considered such intervention warranted in order to mitigate volatility; it embarked on a programme of regular,<sup>1</sup> pre-announced currency sales in mid-September; and it conducted large individual trades in connection with non-residents' transactions with domestic securities and offshore króna assets.

The scale of the Bank's foreign currency market activity differed from month to month. The Bank conducted no trades in January and February, and its biggest month was October, when it sold currency for roughly 38 b.kr. In accordance with its stated policy of intervening in the market to mitigate volatility when it considers such intervention warranted, the Bank purchased currency on several occasions in May, June, and December, when the exchange rate had risen and volatility had increased.

Turnover in the interbank foreign exchange market totalled 426 b.kr. (2.7 billion euros) in 2020, an increase of 124% relative to 2019. The Bank's transactions in the market totalled 156.1 b.kr. (979 million euros), or 37% of total turnover, as compared with 7.5% of total turnover in 2019.

At the end of 2020, the Central Bank's International reserves amounted to 816.7 b.kr., some 5.2 b.kr. less in króna terms than at year-end 2019. In US dollar terms, however, the reserves contracted by 0.4 billion dollars, to a total of 6.4 billion dollars at the year-end. At that time, the reserves totalled 30% of GDP and 36% of broad money holdings (M3), and they covered nine months' worth of goods and services imports. The Republic of Iceland issued a eurobond in the amount of 500 million

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<sup>1</sup> <https://www.cb.is/publications/news/news/2020/09/09/Central-Bank-to-begin-regular-programme-of-foreign-currency-sales/>

euros in June and retired a bond for 292 million euros at maturity in July.

Interest payments on Treasury foreign loans totalled 2.3 b.kr., and other foreign exchange transactions came to 5.2 b.kr. Price changes in the markets increased the international reserves by 9.8 b.kr., and exchange rate movements led to an increase of 89 b.kr. Interest income net of interest expense on the Central Bank's external assets and liabilities totalled 6.2 b.kr. At the end of 2020, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 566 b.kr., as compared with 611 b.kr. at the end of 2019.

The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 572 b.kr. at year-end 2020, as opposed to 646 b.kr. at the end of 2019.

**Table 1. Foreign exchange market, exchange rate, and international reserves**

		2018	2019	2020
ISK exchange rate (-depreciation / +appreciation)	%	-6.4%	-3.1%	-10.4%
Exchange rate volatility <sup>1</sup>	%	8.4%	7.1%	8.5%
FX market turnover	b.kr.	188	191	426
Central Bank share	%	2.0%	7.6%	36.6%
FX market purchases, Central Bank	b.kr.	0.4	2.4	11.7
FX market sales, Central Bank	b.kr.	3.3	11.9	144.4
Net purchases, Central Bank	b.kr.	-2.9	-9.5	-132.7
Reserves in USD	USD m	6,328	6,787	6,420
Reserves in b.kr.	b.kr.	736	822	817
Reserves financed domestically <sup>2</sup>	b.kr.	591	611	566
Central Bank foreign exchange balance <sup>3</sup>	b.kr.	627	646	572
Reserves, as % of GDP <sup>4</sup>	%	26%	28%	30%
Reserves, equivalent months of imports <sup>5</sup>		8	9	9

1. Standard deviation of daily exchange rate movements, annualised.

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

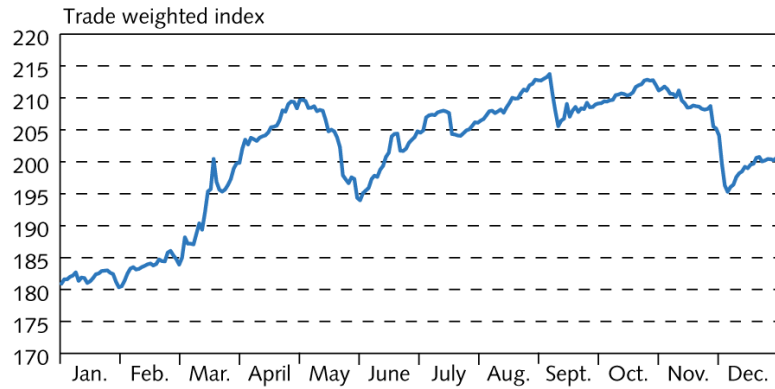
3. Difference between assets and liabilities in foreign currency.

4. Based on Central Bank of Iceland year-2020 GDP forecast.

5. Five-year average.

Chart 1

### Exchange rate of the Icelandic króna 2020

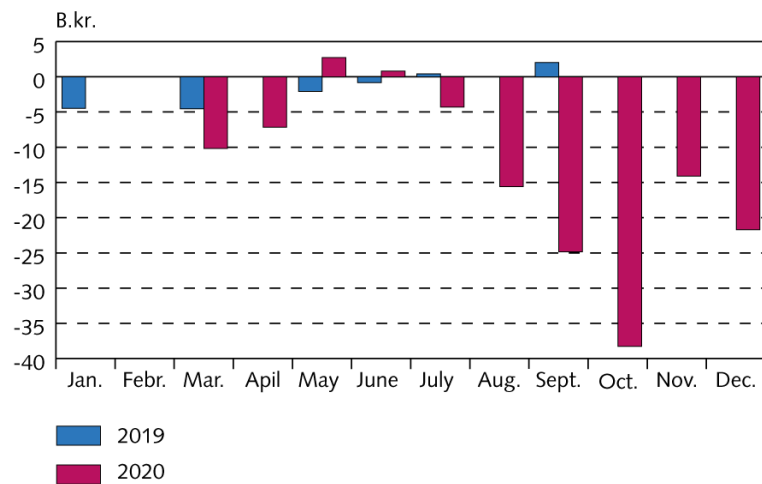


Narrow trade basket. An increase in the series indicates a depreciation and a decline indicates an appreciation.

Source: Central Bank of Iceland.

Chart 2

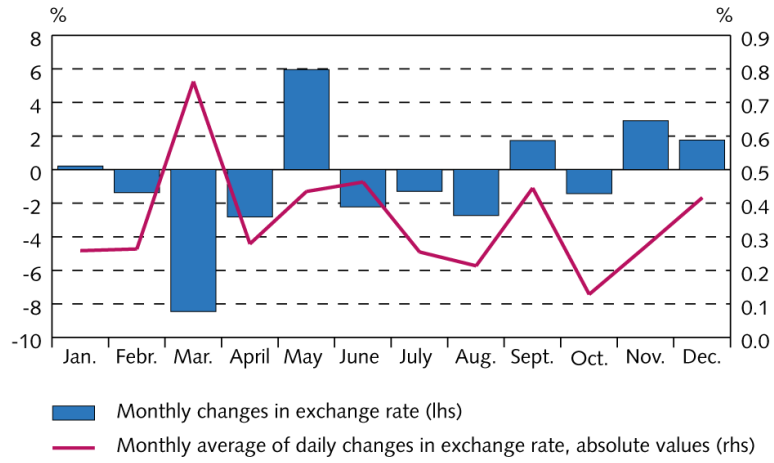
### Net Central Bank foreign exchange transactions 2019-2020



Source: Central Bank of Iceland.

Chart 3

Short term changes in exchange rate 2020



Source: Central Bank of Iceland.