

Monetary policy and instruments

The objective and implementation of monetary policy

The objective of monetary policy is price stability. On March 27, 2001, a formal inflation target was adopted, as follows:¹

- The Central Bank aims for an annual rate of inflation, measured as the twelve-month increase in the CPI, which in general will be as close as possible to 2½%.
- If inflation deviates by more than 1½ percentage points from the target, the Central Bank shall be obliged to submit a report to the Government explaining the reason for the deviation, how it intends to respond, and when it expects the inflation target to be reached again. This report shall be made public.
- The Central Bank shall publish inflation forecasts, projecting inflation three years into the future. Forecasts shall be published in the Bank's *Monetary Bulletin*, which shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

Because monetary policy aims at maintaining price stability, it will not be applied in order to achieve other economic targets, such as a balance on the current account or a high level of employment, except insofar as these are consistent with the Bank's inflation target.

Main monetary policy instruments

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily by determining the interest rate for its collateral loan agreements with financial institutions, which then affects other interest rates. Yields in the money market also have a strong impact on currency flows and thereby on the exchange rate, and in the long run on domestic demand. Generally speaking, transactions with financial institutions can be classified as regular facilities and other facilities. Transactions between financial institutions and the Central Bank are subject to the Rules on Central Bank of Iceland Facilities for Financial Undertakings, no. 553 of June 26, 2009.

Fixed trading instruments

- Current accounts: Current accounts are deposits of financial institutions' undisposed assets. They function as settlement accounts for financial institutions' transactions and are used for reserve requirements. Interest rates on current accounts set the floor for overnight interest rates in the interbank market for krónur. Current accounts must always have a positive balance at the end of each business day.

1. Joint declaration of the Government of Iceland and the Central Bank of Iceland. Published on the Central Bank of Iceland website.

- **Overnight loans:** Overnight loans are loans granted until the following business day. Their primary purpose is to provide financial institutions with access to liquidity so as to ensure that they fulfil reserve requirements and have a positive current account balance at the end of the day. Overnight loans are granted against collateral in securities. Overnight interest rates form the ceiling for overnight rates in the interbank market for krónur.

Regular facilities

Regular facilities can be granted for up to seven days. Their purpose is to increase or reduce the supply of market liquidity. The Central Bank decides in each instance how much liquidity it lends to financial institutions or drains from the market. In general, Central Bank facilities are transacted on Wednesdays; however, the Bank may engage in transactions on other days if necessary. If the Central Bank wishes to carry out transactions with collateral loans and certificates of deposit, it requests that financial institutions submit bids.

- **Collateral loans:** Collateral loans have a maturity of seven days or less. Financial institutions must provide collateral that the Bank deems eligible for Central Bank facilities.
- **Certificates of deposit:** Certificates of deposit are issued with a maturity of seven days or less and are sold by the Central Bank to financial institutions.

In its auctions, the Central Bank may decide to keep interest rates and prices fixed or give financial institutions the option of bidding on either or both. The Bank may reject all bids or a portion of them.

Other financial instruments that the Central Bank may use to increase or decrease market liquidity are repurchase agreements, currency swap agreements, and term deposits.

Other facilities:

The Central Bank may decide to carry out transactions with financial institutions for periods longer than a week, but with the same financial instruments as are used in regular facilities.

Reserve requirements

Required reserves apply to financial institutions that are not dependent on Treasury budget allocations for their operations. The required reserve base comprises deposits, issued securities, and money market instruments. The required reserve ratio is 2% for the part of the required reserve base that is tied for two years or less. The maintenance period is from the 21st day of each month until the 20th of the following month, and the average reserves must reach the stipulated ratio during the period. Reserve requirements do not apply to foreign branches of Icelandic financial institutions.

Intervention in the foreign exchange market

In keeping with the declaration on the inflation target from 2001, foreign exchange market intervention is employed only if the Central Bank deems it necessary in order to promote the attainment of the inflation target or considers exchange rate fluctuations a potential threat to financial stability.

Temporary measures

Because of the extraordinary circumstances that developed in the financial markets in October 2008, the exchange rate of the króna will temporarily have a greater impact on interest rate decisions than it did before that time.

Overview of Central Bank interest rates October 30, 2009

<i>Traditional instruments</i>	<i>Current rate (%)</i>	<i>Last change</i>		<i>Rate one year ago (%)</i>
		<i>Date</i>	<i>Percentage points</i>	
Current accounts	9.50	May 7, 2009	-3.00	11.50
Overnight loans	14.50	Sep. 24, 2009	-1.50	20.00
Required reserves	9.50	May 7, 2009	-3.00	11.50
Collateral loans	12.00	June 4, 2009	-1.00	18.00
Certificates of deposit, 7 days	-	May 7, 2009	-3.00	17.75

Central Bank of Iceland interest rate decisions

<i>Interest rate decision date</i>	<i>Central Bank main interest rates, %¹</i>	
	<i>Collateral loan rate</i>	<i>Financial institutions' current account rates</i>
November 5, 2009	11.00 (-1.00)	9.00 (-0.50)
September 24, 2009	12.00 (0.00)	9.50 (0.00)
August 13, 2009	12.00 (0.00)	9.50 (0.00)
July 2, 2009	12.00 (0.00)	9.50 (0.00)
June 4, 2009	12.00 (-1.00)	9.50 (0.00)
May 7, 2009	13.00 (-2.50)	9.50 (-3.00)
April 8, 2009	15.50 (-1.50)	12.50 (-1.50)
March 19, 2009	17.00 (-1.00)	14.00 (-1.00)
January 29, 2009	18.00 (0.00)	15.00 (0.00)
December 17, 2008	18.00 (0.00)	15.00 (-2.50)
November 6, 2008	18.00 (0.00)	17.50 (0.00)
October 28, 2008	18.00 (6.00)	17.50 (6.00)
October 15, 2008	12.00 (-3.50)	11.50 (-3.50)
September 11, 2008	15.50 (0.00)	15.00 (0.00)
July 3, 2008	15.50 (0.00)	15.00 (0.00)
May 22, 2008	15.50 (0.00)	15.00 (0.00)
April 10, 2008	15.50 (0.50)	15.00 (0.50)
March 25, 2008	15.00 (1.25)	14.50 (1.25)
December 20, 2007	13.75 (0.00)	13.25 (0.00)
November 1, 2007	13.75 (0.45)	13.25 (0.50)
September 6, 2007	13.30 (0.00)	12.75 (0.00)
July 5, 2007	13.30 (0.00)	12.75 (0.00)

1. Change from last decision in parentheses.

