Changes in implementation of the special reserve requirement on capital inflows

Why is there still a special reserve requirement?

The special reserve requirement on capital flows into the bond market and high-yielding deposits was imposed because such inflows had disturbed the monetary policy transmission mechanism, and there was the risk of an overshooting of the exchange rate before export controls were lifted. The special reserve requirement also prevented the accumulation of risk in the financial system as a result of carry trade. The disturbance of the monetary policy transmission mechanism manifested itself in bond interest rates, which were pushed downwards by capital inflows at a time when the Central Bank was trying to raise them in order to tighten the monetary stance. As a result, the exchange rate of the króna rose more than it would have done otherwise. At that time, it was considered appropriate that the tighter monetary stance should take place more through the interest rate channel of monetary policy, which affected the non-tradable sector more strongly, rather than through the exchange rate channel, which affected the tradable sector. The Central Bank has reiterated that it views the application of this policy instrument as a measure to be used primarily when conventional economic and macroprudential tools are insufficient. The Bank has also stated that, other things being equal, the conditions for a reduction in the special reserve ratio would improve as the interest rate differential with abroad narrowed and the exchange rate of the króna fell. The interest rate spread has narrowed since the special reserve requirement was imposed, and the exchange rate of the króna has fallen in the recent term. Therefore, conditions allowed for a reduction in the special reserve ratio in November. Because the interest rate differential with abroad is still considerable and there is limited experience of the impact of reducing the special reserve ratio, it is considered appropriate to proceed with caution and lower the ratio in steps.

Why is the special reserve requirement being changed?

Until now, the parties concerned were required to satisfy the special reserve requirement by depositing funds to a term deposit account with a deposit institution. This arrangement is considered to have complicated matters for investors interested in investing in Iceland, as their funds are tied up unequivocally for the entire holding period, which in some instances may be in contravention of investment strategies and rules. In response to this, the amendments provide for increased flexibility as regards the form of the special reserve requirement on new inflows of foreign currency. It will remain possible to satisfy the special reserve requirement by depositing funds to a term deposit account in the same manner as before.

What is being changed?

The amendments make it possible to satisfy the special reserve account via repo transactions with Central Bank certificates of deposit, which is expected to have an economic impact comparable to that of deposits to a special reserve account. In these transactions, investors will relinquish returns during the holding period, just as if they had deposited funds to a special reserve account. Furthermore, the new arrangement allows investors to release funds by settling with a financial institution the expense deriving from holding funds throughout the holding period.

How is the new arrangement carried out?

The new arrangement entails that the financial institution acting as intermediary for the investment purchases Central Bank certificates of deposit using the special reserve amount and sells them via forward contract to the Central Bank, subject to delivery at the end of the holding period. The financial institution then brokers the terms and holding of the securities to the investor. In other respects, brokerage arrangements are in the hands of the financial institution. Examples of such arrangements are:

1. The financial institution transfers the certificate of deposit to the investor.
2. The financial institutions accepts a deposit from the investor on comparable terms and holds it for the entire holding period.
3. The financial institution and the investors conduct derivatives transactions between them.

The investor may interrupt the holding period on the terms offered by the financial institution in accordance with customary banking transactions, adjusted for the remaining holding period; for instance, by selling the certificate of deposit back to the financial institution or by settling the derivatives transactions that pertain to it.

What impact will these changes have?

The increased opportunities for foreign investors to engage in transactions of this type are conducive to enhancing their interest in investing in Iceland and may therefore stimulate demand in the securities market.

Can those who have already satisfied the special reserve requirement take advantage of the new arrangement?

Those investors or financial institutions that satisfied the holding period before this change took place and hold funds in term deposit accounts can change the agreement concerning the holding to accord with the new arrangement.

Can the special reserve amount change during the holding period?

The special reserve amount remains unchanged throughout the original holding period. This entails that even though the special reserve ratio (currently 20%) is lowered or the holding period (currently 12 months) is shortened, this will not affect special reserve amounts already deposited to special reserve accounts (the previous arrangement) or the terms of repo transactions with Central Bank certificates of deposit (the new arrangement).