Monetary policy and instruments

The objective and implementation of monetary policy

The objective of monetary policy is to ensure price stability. On 27 March 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 macroeconomic and inflation forecasts, projecting 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 key 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 objectives, 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

The Central Bank implements it's monetary policy mainly by applying interest rates with the objective of affecting short-term money market rates, which in turn affect other market 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. 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 26 June 2009.

Standing facilities

- Current accounts: Current accounts are deposits of financial institutions' undisposed assets. They also function as settlement accounts for financial institutions' transactions and are used for reserve requirements. The current account rate forms the floor of the Central Bank interest rate corridor and the interest rate floor in the interbank market for krónur. Current accounts must always have a positive balance at the end of each business day.
- Overnight loans: Overnight loans are loans granted by the Central Bank to financial institutions, upon the request of the latter, until the following business day. Their primary purpose is to provide financial institutions with access to liquidity so as to ensure that the financial institutions concerned fulfil reserve requirements and have

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

a positive current account balance at the end of the day. Overnight loans are granted against eligible collateral. 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 decrease the supply of liquidity in the financial system. 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. The main types of regular facilities are:

- Collateralised loans: Loans with a maturity of up to seven days. Financial institutions must provide collateral that the Bank deems eligible for Central Bank facilities.
- Term deposits with a maturity of up to seven days, which are sold by the Central Bank to financial institutions (for a discussion on longer-term deposits, see *Other facilities*).

As a rule, only one type of regular facility will be offered at any given time, depending on whether the Bank wishes to increase or decrease the supply of liquidity in circulation. 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, certificates of deposit, and currency swap agreements.

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.

Beginning in autumn 2009, the Central Bank sold 28-day certificates of deposit to financial institutions on a weekly basis, with the aim of reducing market liquidity and supporting interest rate formation in the interbank market for krónur. In May 2014, however, it began selling seven-day certificates of deposit, as well as monthly certificates of deposit that are offered once a month.

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 two-month average reserve 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.

Overview of Central Bank interest rates 21 May 2014

Traditional instruments	*Current rate (%)*	*Change (percentage points)*	*Last interest rate decision*	*Rate one year ago (%)*
Current accounts	5.00	0.00	19 March 2014	5.00
Required reserves	5.00	0.00	19 March 2014	5.00
Term deposits with a maturity of up to 7 days	5.25	-	-	-
Overnight loans	7.00	0.00	19 March 2014	7.00
Collateralised loans	6.00	0.00	19 March 2014	6.00

Central Bank of Iceland interest rate decisions

	Key Central Bank interest rates, %[1]				
Interest rate decision date	*Financial institutions' current acc. rate*	*Term deposits with a maturity of up to 7 days*	*Maximum rate on 28-day CDs*	*Collateralised lending rate*	*Overnight loans*
21 May 2014	5.00 (0.00)	5.25 .	. .	6.00 (0.00)	7.00 (0.00)
19 March 2014	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
12 February 2014	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
11 December 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
6 November 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
2 October 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
21 August 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
12 June 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
15 May 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
20 March 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
6 February 2013	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
12 December 2012	5.00 (0.00)		5.75 (0.00)	6.00 (0.00)	7.00 (0.00)
14 November 2012	5.00 (0.25)		5.75 (0.25)	6.00 (0.25)	7.00 (0.25)
3 October 2012	4.75 (0.00)		5.50 (0.00)	5.75 (0.00)	6.75 (0.00)
22 August 2012	4.75 (0.00)		5.50 (0.00)	5.75 (0.00)	6.75 (0.00)
13 June 2012	4.75 (0.25)		5.50 (0.25)	5.75 (0.25)	6.75 (0.25)
16 May 2012	4.50 (0.50)		5.25 (0.50)	5.50 (0.50)	6.50 (0.50)
21 March 2012	4.00 (0.25)		4.75 (0.25)	5.00 (0.25)	6.00 (0.25)
8 February 2012	3.75 (0.00)		4.50 (0.00)	4.75 (0.00)	5.75 (0.00)
7 December 2011	3.75 (0.00)		4.50 (0.00)	4.75 (0.00)	5.75 (0.00)
2 November 2011	3.75 (0.25)		4.50 (0.25)	4.75 (0.25)	5.75 (0.25)
21 September 2011	3.50 (0.00)		4.25 (0.00)	4.50 (0.00)	5.50 (0.00)
17 August 2011	3.50 (0.25)		4.25 (0.25)	4.50 (0.25)	5.50 (0.25)
15 June 2011	3.25 (0.00)		4.00 (0.00)	4.25 (0.00)	5.25 (0.00)
20 April 2011	3.25 (0.00)		4.00 (0.00)	4.25 (0.00)	5.25 (0.00)
16 March 2011	3.25 (0.00)		4.00 (0.00)	4.25 (0.00)	5.25 (0.00)
2 February 2011	3.25 (-0.25)		4.00 (-0.25)	4.25 (-0.25)	5.25 (-0.25)
8 December 2010	3.50 (-0.50)		4.25 (-1.00)	4.50 (-1.00)	5.50 (-1.50)
3 November 2010	4.00 (-0.75)		5.25 (-0.75)	5.50 (-0.75)	7.00 (-0.75)
22 September 2010	4.75 (-0.75)		6.00 (-0.75)	6.25 (-0.75)	7.75 (-0.75)
18 August 2010	5.50 (-1.00)		6.75 (-1.00)	7.00 (-1.00)	8.50 (-1.00)
23 June 2010	6.50 (-0.50)		7.75 (-0.50)	8.00 (-0.50)	9.50 (-0.50)
5 May 2010	7.00 (-0.50)		8.25 (-0.50)	8.50 (-0.50)	10.00 (-0.50)
17 March 2010	7.50 (-0.50)		8.75 (-0.50)	9.00 (-0.50)	10.50 (-0.50)
27 January 2010	8.00 (-0.50)		9.25 (-0.50)	9.50 (-0.50)	11.00 (-0.50)
10 December 2009	8.50 (-0.50)		9.75 (-0.25)	10.00 (-1.00)	
5 November 2009	9.00 (-0.50)		10.00	11.00 (-1.00)	
24 September 2009	9.50 (0.00)			12.00 (0.00)	
13 August 2009	9.50 (0.00)			12.00 (0.00)	
2 July 2009	9.50 (0.00)			12.00 (0.00)	

1. Change from last decision in parentheses.