

Monetary policy and instruments

The target and implementation of monetary policy

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

- The Central Bank aims for an annual rate of inflation, measured as the annual twelve-month increase in the CPI, which in general will be as close as possible to 2½%.
- If inflation deviates by more than ±1½% 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 once again. This report shall be made public.
- The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's *Monetary Bulletin*. This 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.

Since 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 this is consistent with the Bank's inflation target.

The Central Bank announces interest rate decisions on scheduled, prearranged dates. Before an interest rate decision is made, the Board of Governors convenes monetary policy meetings, as detailed in the Bank's Internal rules on the preparation, rationale and presentation of monetary policy decisions, which are set pursuant to the provisions of the Central Bank Act. The Internal rules are published on the Central Bank website, www.sedlabanki.is.

Main monetary policy instruments

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily through interest rate decisions for its repurchase agreements with credit institutions. Yields in the money market have a strong impact on currency flows

Overview of Central Bank interest rates October 20, 2006

	Current rate (%)	Last change		Rate one year ago (%)
		Date	Percentage points	
Current accounts	12.50	Sept. 21, 2006	0.50	8.00
Overnight loans	15.00	Sept. 21, 2006	0.50	11.00
Certificates of deposit, 90 days	-	July 11, 2006	-	9.75
Required reserves	12.75	Sept. 21, 2006	0.50	8.75
Repos (yield)	14.00	Sept. 19, 2006	0.50	9.50
Certificates of deposit, 7 days (yield)	13.85	Sept. 19, 2006	0.50	9.35

and thereby on the exchange rate, and in the long run on domestic demand. Broadly speaking, transactions with credit institutions can be classified into fixed trading instruments and market actions.

Fixed trading instruments:

- *Current accounts* are deposits of the credit institutions' undisposed assets. These are settlement accounts for netting between deposit institutions and for interbank market trading, including transactions with the Central Bank. Interest rates on these accounts set the floor for overnight interest rates in the interbank market.
- *Overnight loans* are provided on the request of credit institutions and secured with the same securities that qualify for repo transactions (see below). Overnight interest rates form the ceiling for overnight interest rates in the interbank market.
- *Certificates of deposit* are issued with a maturity of 90 days, on the request of credit institutions. Although they are unlisted, they qualify for repo transactions. Their role is to establish the floor for three-month yields in the money market.
- *Required reserves* are made with the Central Bank by credit institutions which 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 which is tied for two years or less. The maintenance period is based on the 21st day of each month until the 20th of the following month, and the two-month average reserve is required to reach the stipulated ratio during the period.

Market operations:

- *Repurchase agreements* are the Central Bank's main instrument. Auctions of 7-day agreements are held every week. Credit institutions need to put up securities that qualify as collateral, as specified in the Central Bank's Rules No. 997 of December 10, 2004. Auctions can be fixed-price or auctions where total amount is announced. Fixed-price auctions have been used so far.
- *Certificates of deposit* with a maturity of 7 days are auctioned weekly. Their function is to counteract temporary surplus liquidity in the banking system. The auction format is fixed-price.
- *Securities* market trading is limited to Treasury-guaranteed paper.
- *Foreign exchange market intervention* is employed only if the Central Bank considers this necessary in order to promote its inflation target or sees exchange rate fluctuations as a potential threat to financial stability.