

Domestic foreign exchange market and foreign exchange reserves 2013

From now on, the Central Bank will report at the beginning of each year on foreign exchange market developments and changes in the foreign exchange reserves during the preceding year. Early in 2013, after a period of marked ISK depreciation in the final months of 2012, the Central Bank decided to suspend its programme of regular foreign currency purchases, and the króna appreciated significantly thereafter. On 15 May 2013, the Bank's Monetary Policy Committee (MPC) introduced a new policy of more active intervention in the foreign exchange market, which significantly reduced day-to-day fluctuations and overall exchange rate volatility for the remainder of the year. The króna appreciated by nearly 11% in trade-weighted terms in 2013. During the year, the Bank's net foreign exchange purchases totalled 9 million euros, or just over 1.0 b.kr.¹ Some of the forward agreements concluded at the end of 2010 in order to reduce foreign currency imbalances in the banking system were settled, strengthening the Bank's foreign exchange position by over 29 b.kr. Also concluded during the year were foreign exchange agreements entailing foreign currency outflows in the amount of 6 b.kr.

Foreign exchange market

The exchange rate of the króna fluctuated somewhat during the first half of the year, bottoming out in January and peaking in May. The difference between peak and trough measured 12.2%. During the period from 2 January through 15 May, the day the Bank announced its new intervention policy, the exchange rate rose by about 7%, after having fallen significantly from its strongest point. The appreciation over the summer was less pronounced than often before, but towards the end of the year the króna strengthened markedly, in a departure from the seasonal pattern of recent years.

As is stated above, the Bank announced early in 2013 that it would suspend its regular foreign currency purchases temporarily, in part due to heavy debt service on Icelandic residents' foreign loans. During the first quarter, the Bank sold 36 million euros (6.1 b.kr.) in the foreign

¹ Calculated using the exchange rate in each individual transaction.

exchange market, in addition to selling the equivalent of 6 b.kr. in forward transactions.

According to the MPC's statement of 15 May 2013, the Bank intended to intervene in the market with the aim of mitigating short-term exchange rate volatility.² In July, the Bank began buying foreign currency in the market. From 15 May until year-end, it bought 63 million euros (19 b.kr.) and sold 18 million euros (2.9 b.kr.). For the year as a whole, the Bank's net foreign currency purchases in the interbank market totalled 9 million euros, or just over 1.0 b.kr. Including payments on forward contracts, the Bank acquired foreign currency in the amount of 143.4 million euros, or 22.7 b.kr. in excess of the amount sold. This amount was used to reinforce the foreign exchange reserves. Foreign exchange market turnover was virtually unchanged from the prior year, at 166 b.kr., and the Central Bank accounted for 11.5%, a somewhat smaller share than in 2012.

Exchange rate volatility diminished substantially in the wake of the MPC's May 2013 announcement. Volatility in the trade-weighted exchange rate index (measured in terms of the standard deviation of daily changes) measured just under 0.4% over the year as a whole. It had measured 0.6% before the Bank stepped up its intervention in the market but diminished sharply thereafter. It measured 0.3% after 15 May and has been negligible in the recent past. The MPC's announcement and the Bank's foreign exchange market activity therefore appear to have contributed, along with other factors, to reduced exchange rate volatility during the year.

Foreign exchange reserves

The Central Bank's foreign exchange reserves grew by 45 million US dollars in 2013, to a year-end total of 4,228 million US dollars. Foreign exchange transactions and settlement of forward contracts increased the reserves by the equivalent of 22.7 b.kr. over the same period. By the end of the year, the foreign exchange reserves totalled 29% of GDP. This corresponds to about 11 months' worth of imports, a slight decline from the previous year. The book value of foreign assets held in the reserves declined by 52 b.kr. during the year, owing primarily to the appreciation of the króna, but also to changes in the value of gold and securities held in the reserves.

² See Central Bank of Iceland press release no. 16/2013: Monetary Policy Committee statement of 15 May 2013: <http://www.cb.is/publications-news-and-speeches/news-and-speeches/news/2013/05/15/Statement-of-the-Monetary-Policy-Committee-15-May-2013/>

At the end of 2013, the Central Bank purchased a foreign-denominated claim against a domestic financial institution from the Central Bank of Iceland Holding Company (ESÍ). The amount of the claim was 52 b.kr. At the same time, ESÍ settled a foreign-denominated loan with the Central Bank. The claim in question will not increase the foreign exchange reserves until it is settled, as claims against domestic parties are not included in the reserves.

The following table explains these items.

Domestic foreign exchange market and foreign exchange reserves

		<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Exchange rate (-depreciation/+appreciation)	%	-7.0%	11.9%	-4.3%	-6.6%	10.8%
Exchange rate volatility	%	0.8%	0.3%	0.2%	0.3%	0.4%
FX market turnover	m.kr.	62,427	45,212	89,864	167,115	165,873
- FX market turnover, Central Bank		23.9%	66.3%	14.0%	13.8%	11.6%
FX market purchases, Central Bank	m.kr.	0	29,980	12,612	20,109	10,088
FX market sales, Central Bank	m.kr.	14,937	0	0	3,012	9,068
Net purchases, Central Bank	m.kr.	-14,937	29,980	12,612	17,097	1,020
Net forward purchases, Central Bank	m.kr.	-	47,900	-	-	-6,000
Net settlement of forward FX purchases	m.kr.		0	-	-	21,300
Foreign exchange reserves, in US dollars*	m. USD	3,883	5,798	8,535	4,182	4,228
Foreign exchange reserves, in krónur	b.kr.	484.9	667.0	1,047.3	539.8	496.6
Foreign exchange reserves, as % of GDP		32.4%	43.4%	64.3%	33.0%	29.0%
Foreign exchange reserves, equivalent months of imports		14	17	26	13	11

*The reduction in the foreign exchange reserves in 2012 is due to reduced foreign exchange balances of the financial institutions undergoing winding-up proceedings. Other changes were due to Treasury borrowings in the market and the Treasury and Central Bank's prepayment of loans from the Nordic countries and the IMF.

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