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Foreign exchange market, exchange rate developments, and international reserves 2019

The króna depreciated by 3.1% in 2019, and total turnover in the interbank market for foreign currency was similar to that in 2018. The Central Bank's foreign exchange market transactions during the year were conducted with two main objectives: to mitigate excessive short-term exchange rate volatility and to ensure that outflows related to the release of offshore krónur did not affect the exchange rate. The Bank's net foreign currency sales in the market totalled 9.5 b.kr. during the year. Exchange rate volatility was less pronounced than in 2018. Major amendments were made to statutory provisions on offshore krónur, and the special reserve requirement on new capital inflows was lowered from 20% to 0%. At the year-end, the international reserves totalled 822 b.kr., or 28% of GDP.

The króna was relatively stable in 2019. It depreciated by 3.1% from the beginning to the end of the year. It depreciated by 1.9% against the euro and by 3.9% against the US dollar. The króna was strongest at the beginning of the year and weakest in July. The spread between the highest and lowest listed exchange rate indices for the year was 7.2%. The most pronounced change in the exchange rate was in July (an increase of 4.7%), while the smallest change was in February (a decrease of 0.6%).

In the first three months of the year, the króna depreciated by 4.3%, owing in part to the uncertainty surrounding the fate of airline WOW Air, which discontinued operations at the end of March. The decline was small in comparison with that in autumn 2018, and it appears that to some extent, the impact of the airline's insolvency had already been priced into the exchange rate. At the beginning of March, amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016, entered into force, and amendments were made to the Rules on Special Reserve Requirements for New

Foreign Currency Inflows.¹ The amendments to Act no. 37/2016 had been announced on 7 December 2018.² The amendments to the Act, which entailed the removal of capital controls on owners of offshore krónur, represented the elimination of virtually all of the capital controls introduced in November 2018. With the amendments to the Rules on Special Reserve Requirements, the special reserve ratio on inflows of capital for investment in bonds and high-yielding deposits was lowered from 20% to 0%. The Rules were amended because of reduced probability of large-scale inflows that could cause an overshooting of the króna and severe disturbances in the monetary policy transmission mechanism, as the interest rate differential had narrowed and capital flows to and from Iceland were better balanced than they were when the special reserve requirement was first imposed. The pension funds were major purchasers of foreign currency, as in 2018.³

In January, the Central Bank sold foreign currency four days in a row, so as to offset an abrupt weakening of the króna. In March, May, and June, the Bank sold currency to offset outflows of offshore krónur and to prevent excess short-term volatility stemming from other causes. In the first half of the year, the Bank sold currency for 11.9 b.kr., while in the second half, it bought currency for 2.4 b.kr. The H2 purchases took place on two business days in July and September. In all, the Bank traded in foreign currency on 12 separate days during the year.

Turnover in the interbank foreign exchange market totalled 188.3 b.kr. (EUR 1,376 million) in 2019, broadly the same as in 2018. The Central Bank's turnover in the interbank market totalled 14.4 b.kr. (EUR 105 million) in 2019, as compared with 3.7 b.kr. (EUR 27 million) in 2018. In 2019 as a whole, the Bank sold currency for 11.9 b.kr. (EUR 87 million) and bought currency for 2.4 b.kr. (EUR 18 million).

The Bank's international reserves increased by roughly 86 b.kr. in 2019, to 822 b.kr. by the year-end. In US dollar terms, however, they increased

¹ <https://www.cb.is/publications/news/news/2019/03/04/Removal-of-capital-controls-on-holders-of-offshore-kronur-and-reduction-of-special-reserve-requirement-on-capital-inflows/>

² <https://www.sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2018/12/07/Frumvarp-um-breytingu-a-logum-losun-fjarmagnshafta-a-aflandskronueigendur-og-bindingarskylda-a-fjarmagnsinnstreymi/>

³For further information, see *Financial Stability* 2019/1: <https://www.cb.is/publications/publications/publication/2019/04/04/Financial-Stability-2019-1/>

by 0.5 billion dollars, to a total of 6.8 billion dollars at the year-end. At that time, the reserves totalled 28% of GDP and 42% of broad money holdings (M3), and they covered nine months' worth of goods and services imports. The Republic of Iceland issued a eurobond in the amount of EUR 500 million in June 2019 and bought back outstanding bonds with a nominal value of EUR 60 million. The net impact of this was to increase the international reserves by 62 b.kr.

The Central Bank sold foreign currency in the interbank market for the equivalent of 9.5 b.kr., and interest payments on Treasury foreign loans amounted to 2.0 b.kr. Other foreign exchange transactions totalled 8.6 b.kr. Exchange rate movements increased the reserves by 28.3 b.kr. in krónur terms, and investment gains increased them by 14 b.kr. At the end of 2019, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 611 b.kr., as compared with 591 b.kr. at the end of 2018.

The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 646 b.kr. at year-end 2019, as opposed to 627 b.kr. at the end of 2018.

Table 1. Foreign exchange market, exchange rate, and international reserves

		2017	2018	2019
ISK exchange rate (-depreciation / +appreciation)	%	-0.7%	-6.4%	-3.1%
Exchange rate volatility*	%	12.8%	8.4%	7.1%
FX market turnover	b.kr.	407	187	188
– Central Bank share	%	20.4%	2.0%	7.6%
FX market purchases, Central Bank	b.kr.	76.6	0.4	2.4
FX market sales, Central Bank	b.kr.	6.4	3.3	11.9
Net purchases, Central Bank	b.kr.	70.3	-2.9	-9.5
Reserves in USD	USD m	6,571	6,328	6,787
Reserves in b.kr.	b.kr.	686	736	822
Reserves financed domestically**	b.kr.	587	591	611
Central Bank foreign exchange balance***	b.kr.	587	627	646
Reserves, as % of GDP ****	%	26%	26%	28%
Reserves, equivalent months of imports*****		8	8	9

*Standard deviation of daily exchange rate movements, annualised

**International reserves net of Central Bank and Treasury foreign debt

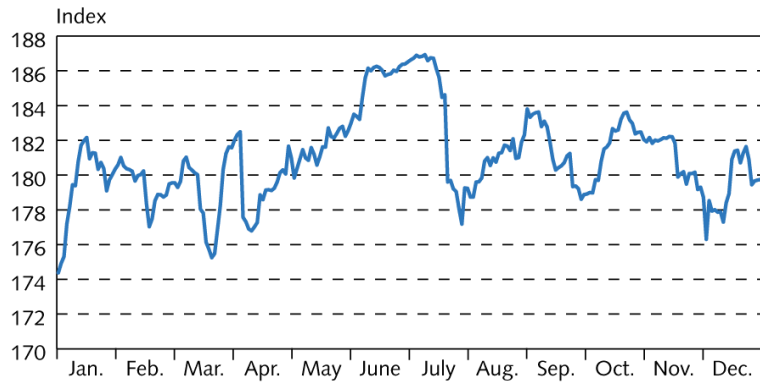
***Difference between assets and liabilities in foreign currency

****Based on Central Bank of Iceland year-2019 GDP forecast

*****Five-year average

Chart 1

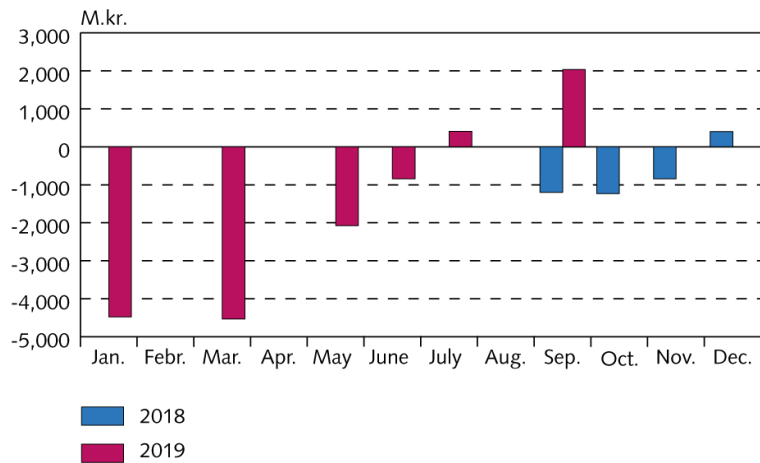
Exchange rate of the króna 2019



Narrow trade basket. A rise in the line indicates a depreciation, and a decline indicates an appreciation.

Chart 2

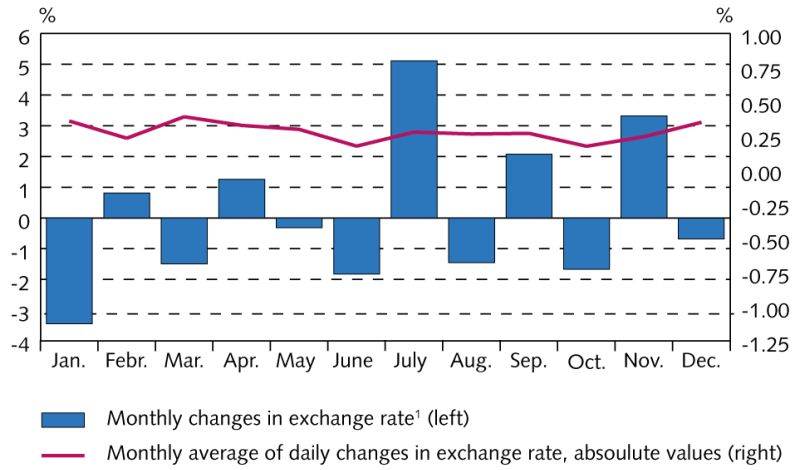
Central Bank foreign exchange market purchases and sales 2018-2019



Positive values indicates purchases and negative sales.
Source: Central Bank of Iceland.

Chart 3

Monthly changes in exchange rate 2019



1. Positive values indicates appreciation and negative depreciation.

Source: Central Bank of Iceland.