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## Foreign exchange market, exchange rate developments, and international reserves 2023

*The króna appreciated by 1.5% in 2023, and turnover in the interbank foreign currency market contracted by 37% year-on-year. The Central Bank intervened in the market twice during the year to mitigate exchange rate volatility. The Bank sold foreign currency for a total of 5.5 b.kr. but did not buy any foreign currency. The exchange rate of the króna fluctuated less in 2023 than in the years immediately preceding. At the beginning of the year, market agents' concerns about the Icelandic banks' foreign funding terms affected the exchange rate to a large extent, but credit spreads on the banks' outstanding bonds began to fall over the course of January. An increase in the capelin catch quota, announced at the end of February, had a positive impact on the foreign exchange market. Foreign capital continued to flow into domestic listed equities during the year, and the third and final phase of the Icelandic equity market's reclassification by index provider FTSE Russell concluded in mid-March. The number of tourists visiting Iceland in 2023 indicates that the sector has regained its previous strength, while the trade deficit was sizeable. The announced acquisition in July of Icelandic biotech firm Kerecis by a Danish company attracted significant notice, as the purchase price of 175 b.kr. was high in Icelandic context. Uncertainty about the impact of seismic activity on Reykjanes peninsula, together with news of financing problems within the owner group of Marel hf. and a possible ownership change, made their mark on the foreign exchange market in November. The interest rate differential with abroad increased over the year and was wider than the average of the past eight years, and foreign investors' holdings in Treasury bonds grew between years. The pension funds were big purchasers of foreign currency during the year, as in the past, but bought less currency than in 2022. The banks' net forward position declined during the year. At the year-end, the Bank's international reserves totalled 790 b.kr., or 20% of GDP.*

### Exchange rate developments

The króna appreciated by 1.5% in listed trade-weighted terms and by 0.7% against the euro in 2023. The króna appreciated over the first eight months of the year but then weakened significantly in September, October, and early November. It held relatively stable in December. The pattern was similar to that in 2022, when the króna appreciated in H1 but depreciated in H2. In 2023, the exchange rate was lowest in January but highest at the end of August. The year's highest listed exchange rate was 10.2% above the lowest, whereas the high-low range in 2022 was 9.5%. Despite a wider range than in 2022, foreign currency flows were better balanced than in recent years. This can be seen in several factors: interbank market turnover was moderate, average daily exchange rate volatility was lower, and the Central Bank intervened far less than in the past several years.

Greater foreign exchange market stability can be attributed in part to better balanced external trade than in the years immediately preceding. No travel restrictions were in place in 2023, for the first time since 2019, and the tourism industry appears to have recovered in full after the COVID-19 pandemic. Some 2.2 million foreign nationals departed via Keflavík Airport in 2023. Only once before, in 2018, have departure numbers been higher. Offsetting tourism-generated foreign currency revenues was a large deficit on goods trade during the year. Although the pension funds were large-scale purchasers of foreign currency, as before, their net purchases totalled 82.7 b.kr., or 21.3 b.kr. less than in 2022. Inflows of foreign capital into domestic listed equities from investment funds continued during the year, and the third and last stage of FTSE Russell's reclassification of the Icelandic equity market to secondary emerging market status took place in mid-March. The interest rate differential with abroad increased and was wider than the eight-year average, but foreign investors' holdings in Treasury bonds grew between years. The commercial banks' net forward position with the Icelandic króna against foreign currencies declined during the year. It increased in H1/2023 but then decreased in H2.

There were several prominent developments during the year that affected the exchange rate. During the first few weeks of 2023, the króna depreciated rather abruptly, after weakening since mid-2022. Wage negotiations were contentious, and tourism employees had proposed strikes. Furthermore, market agents' concerns about the Icelandic commercial banks' foreign funding conditions affected the foreign exchange market early in the year, although they abated when credit spreads on outstanding bank bonds started to fall in the latter half of January. Announcements about listed companies' capital flows also affected the market in January. News of a prospective increase in the capelin catch quota in late February further eased the pressure that had weighed on the exchange rate at the beginning of the year. Amendments made to the Act on Covered Bonds, no. 11/2008, in early March, which enabled the banks to market bonds as European Covered Bonds or European Covered Bonds (Premium) also had a positive impact on the foreign exchange market, but turmoil in the international banking market in March created temporary uncertainty in global financial markets.

The foreign exchange market was well balanced in April and May, and the króna appreciated virtually uninterrupted over the summer. Exchange rate volatility eased at the same time, and interbank market turnover was relatively limited. The announced acquisition in July of Icelandic biotech firm Kerecis by a Danish company prompted expectations of foreign currency inflows to the company's Icelandic shareholders, further strengthening the króna. The purchase price of 175 b.kr. was high by Icelandic standards. Balances on foreign currency accounts in Icelandic banks increased on the settlement date in late August, but they declined again during the months thereafter.

In September, the króna began to weaken again, as there was a sizeable deficit on goods trade in the autumn, particularly in October. News coverage of seismic activity on Reykjanes peninsula made a strong impact on the foreign exchange market in November. After geological activity escalated and the town of Grindavík was evacuated, there was an increase in domestic uncertainty about the effects of a potential volcanic eruption on key infrastructure and tourism industry revenues. Market makers in the interbank market bought currency from one another, while sellers of currency seemed inclined to wait and see. At around that time, news surfaced of financing difficulties among owners of Marel hf., and shortly thereafter it was reported that a US company had entered into a non-binding memorandum of understanding concerning the purchase of all shares in the

company. All of these news reports caused temporary fluctuations in the foreign exchange market. In December, the exchange rate of the króna was relatively stable and moved within a narrow range.

#### Foreign exchange market

Turnover in the interbank foreign exchange market totalled 241.4 b.kr. (1.6 billion euros) in 2023, a decrease of 37% year-on-year. The Central Bank accounted for 2.3% of total turnover, its smallest share since 2018 and far below its 2022 share of 14.2%. The Bank's foreign exchange transactions during the year were in line with its intervention policy, which aims to mitigate short-term exchange rate volatility due to thin market trading conditions and to affect the exchange rate when the Monetary Policy Committee considers it to have deviated too far from underlying economic developments.<sup>1</sup> The Central Bank's foreign currency sales in the interbank market totalled 5.5 b.kr. (36 million euros) in 2023. The Bank bought no currency in the market during the year. The Bank's foreign exchange transactions took place on two business days, one in January and the other in November. In early January, the króna depreciated relatively quickly due to imbalances in foreign currency flows, and on 9 January it fell steeply. That day the Bank sold currency for 2.8 b.kr. (18 million euros). In November, seismic activity on Reykjanes peninsula and news coverage of financing problems within the owner group of Marel hf. affected the foreign exchange market, and the króna weakened sharply in a short period of time. The Bank intervened on 13 November, selling currency in the interbank market for 2.8 b.kr. (18 million euros).

#### International reserves

At the end of 2023, the Central Bank's international reserves amounted to 790 b.kr., some 47 b.kr. less in krónur terms than at year-end 2022. In US dollar terms, the reserves shrank by 0.3 billion dollars, to a total of 5.9 billion dollars at the year-end. At that time, the reserves totalled 20% of GDP and 28% of broad money holdings (M3), and they covered five months' worth of goods and services imports. Buybacks of just over half of the Treasury's June 2024 foreign bond maturities totalled 38 b.kr. These buybacks were the main reason for the decline in reserves during the year.

Market intervention and other foreign exchange transactions reduced the reserves by 27.8 b.kr. Interest income net of interest expense on the Central Bank's external assets and liabilities totalled 24 b.kr. Price changes in the markets increased the international reserves by 10 b.kr., while exchange rate movements led to a decline of 14 b.kr. At the end of 2023, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 506 b.kr., as compared with 522 b.kr. at the end of 2022.

The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by 515 b.kr. at year-end 2023, as opposed to 528 b.kr. at the end of 2022.

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<sup>1</sup>See [Monetary Policy Strategy \[in Icelandic\]](#) (published in March 2023).

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

		2021	2022	2023
ISK exchange rate (+appreciation/-depreciation)	%	2.5%	-2.1%	1.5%
Exchange rate volatility <sup>1</sup>	%	7.0%	7.6%	6.3%
FX market turnover	b.kr.	363	385	241
Central Bank share	%	21.1%	14.2%	2.3%
FX market purchases, Central Bank	b.kr.	26.9	33.9	0.0
FX market sales, Central Bank	b.kr.	49.6	20.7	5.5
Net purchases, Central Bank	b.kr.	-22.7	13.2	-5.5
Reserves in USD	m. USD	7,080	5,888	5,801
Reserves in b.kr.	b.kr.	923	837	790
Reserves financed domestically <sup>2</sup>	b.kr.	489	522	506
Central Bank foreign exchange balance <sup>3</sup>	b.kr.	529	528	515
Foreign exchange reserves, as % of GDP <sup>4</sup>	%	30%	24%	20%

1. Standard deviation of daily exchange rate movements, annualised

2. Foreign exchange reserves net of Central Bank and Treasury foreign debt

3. Difference between assets and liabilities in foreign currency

4. Based on Central Bank of Iceland year-2023 GDP forecast

Chart 1

## Exchange rate of the Icelandic króna 2023

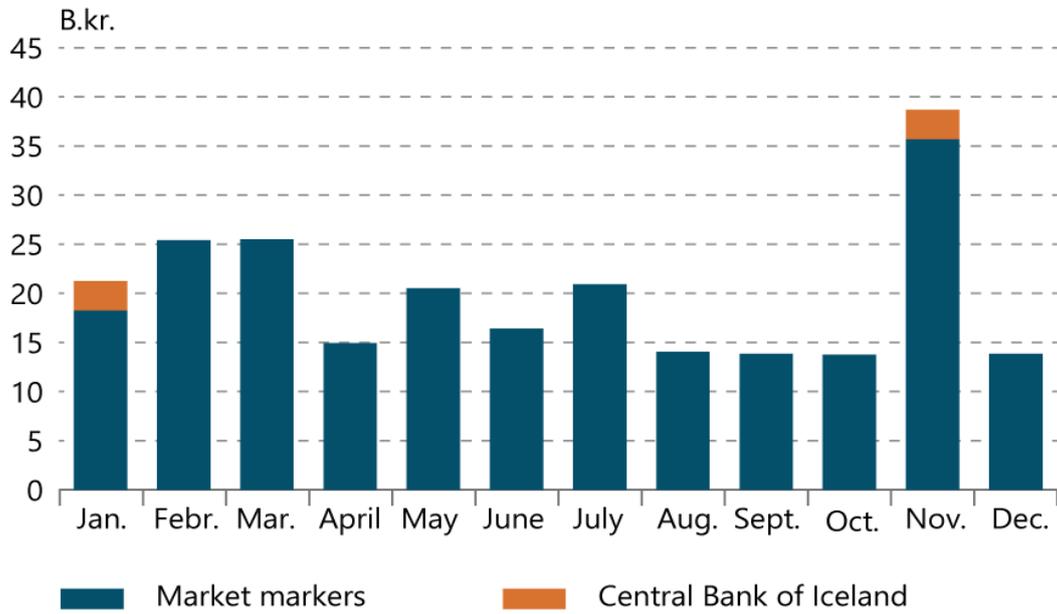


Narrow trade basket. An increase in the series indicates a depreciation of the króna and a decline indicates an appreciation.

Source: Central Bank of Iceland.

Chart 2

## Turnover in the interbank foreign exchange market 2023



Source: Central Bank of Iceland.