# 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 inflation forecasts, projecting inflation 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 main 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 targets, 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**

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily by determining the interest rate for its collateralised loan agreements with financial institutions, which then affects other 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.

***Fixed trading instruments***

- 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

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

financial institutions with access to liquidity so as to ensure that they fulfil reserve requirements and have a positive current account balance at the end of the day. Overnight loans are granted against collateral in securities. 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: Collateralised loans have a maturity of seven days or less. Financial institutions must provide collateral that the Bank deems eligible for Central Bank facilities.
- Certificates of deposit: Certificates of deposit are issued with a maturity of seven days or less and are sold by the Central Bank to financial institutions.

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, currency swap agreements, and term deposits.

***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.

**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 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 14 November 2012

| *Traditional instruments* | *Current rate (%)* | *Change (percentage points)* | *Last interest rate decision* | *Rate one year ago (%)* |
|---|---|---|---|---|
| Current accounts | 5.00 | 0.25 | 3 October 2012 | 3.75 |
| Overnight loans | 7.00 | 0.25 | 3 October 2012 | 5.75 |
| Required reserves | 5.00 | 0.25 | 3 October 2012 | 3.75 |
| Collateralised loans | 6.00 | 0.25 | 3 October 2012 | 4.75 |
| Certificates of deposit, 28 days | 5.75 | 0.25 | 3 October 2012 | 4.50 |

## Central Bank of Iceland interest rate decisions

| | *Key Central Bank interest rates, %*[1] | | | | | |
|---|---|---|---|---|---|---|
| *Interest rate decision date* | *Collateralised lending rate* | | *Financial institutions' current account rates* | | *Maximum rate on 28-day CDs* | |
| 14 November 2012 | 6.00 | (0.25) | 5.00 | (0.25) | 5.75 | (0.25) |
| 3 October 2012 | 5.75 | (0.00) | 4.75 | (0.00) | 5.50 | (0.00) |
| 22 August 2012 | 5.75 | (0.00) | 4.75 | (0.00) | 5.50 | (0.00) |
| 13 June 2012 | 5.75 | (0.25) | 4.75 | (0.25) | 5.50 | (0.25) |
| 16 May 2012 | 5.50 | (0.50) | 4.50 | (0.50) | 5.25 | (0.50) |
| 21 March 2012 | 5.00 | (0.25) | 4.00 | (0.25) | 4.75 | (0.25) |
| 8 February 2012 | 4.75 | (0.00) | 3.75 | (0.00) | 4.50 | (0.00) |
| 7 December 2011 | 4.75 | (0.00) | 3.75 | (0.00) | 4.50 | (0.00) |
| 2 November 2011 | 4.75 | (0.25) | 3.75 | (0.25) | 4.50 | (0.25) |
| 21 September 2011 | 4.50 | (0.00) | 3.50 | (0.00) | 4.25 | (0.00) |
| 17 August 2011 | 4.50 | (0.25) | 3.50 | (0.25) | 4.25 | (0.25) |
| 15 June 2011 | 4.25 | (0.00) | 3.25 | (0.00) | 4.00 | (0.00) |
| 20 April 2011 | 4.25 | (0.00) | 3.25 | (0.00) | 4.00 | (0.00) |
| 16 March 2011 | 4.25 | (0.00) | 3.25 | (0.00) | 4.00 | (0.00) |
| 2 February 2011 | 4.25 | (-0.25) | 3.25 | (-0.25) | 4.00 | (-0.25) |
| 8 December 2010 | 4.50 | (-1.00) | 3.50 | (-0.50) | 4.25 | (-1.00) |
| 3 November 2010 | 5.50 | (-0.75) | 4.00 | (-0.75) | 5.25 | (-0.75) |
| 22 September 2010 | 6.25 | (-0.75) | 4.75 | (-0.75) | 6.00 | (-0.75) |
| 18 August 2010 | 7.00 | (-1.00) | 5.50 | (-1.00) | 6.75 | (-1.00) |
| 23 June 2010 | 8.00 | (-0.50) | 6.50 | (-0.50) | 7.75 | (-0.50) |
| 5 May 2010 | 8.50 | (-0.50) | 7.00 | (-0.50) | 8.25 | (-0.50) |
| 17 March 2010 | 9.00 | (-0.50) | 7.50 | (-0.50) | 8.75 | (-0.50) |
| 27 January 2010 | 9.50 | (-0.50) | 8.00 | (-0.50) | 9.25 | (-0.50) |
| 10 December 2009 | 10.00 | (-1.00) | 8.50 | (-0.50) | 9.75 | (-0.25) |
| 5 November 2009 | 11.00 | (-1.00) | 9.00 | (-0.50) | 10.00 | |
| 24 September 2009 | 12.00 | (0.00) | 9.50 | (0.00) | | |
| 13 August 2009 | 12.00 | (0.00) | 9.50 | (0.00) | | |
| 2 July 2009 | 12.00 | (0.00) | 9.50 | (0.00) | | |
| 4 June 2009 | 12.00 | (-1.00) | 9.50 | (0.00) | | |
| 7 May 2009 | 13.00 | (-2.50) | 9.50 | (-3.00) | | |
| 8 April 2009 | 15.50 | (-1.50) | 12.50 | (-1.50) | | |
| 19 March 2009 | 17.00 | (-1.00) | 14.00 | (-1.00) | | |
| 29 January 2009 | 18.00 | (0.00) | 15.00 | (0.00) | | |

1. Change from last decision in parentheses.