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## Foreign exchange market, exchange rate developments, and international reserves 2021

*The króna appreciated by 2.5% in 2021, and turnover in the interbank foreign currency market contracted by 12% year-on-year. The impact of the COVID-19 pandemic could be felt in the foreign exchange market during the year. The Central Bank conducted transactions in the foreign exchange market in order to mitigate volatility as it deemed warranted, and to improve price formation in the market, albeit to a much lesser degree than in the previous year. The Bank both bought and sold currency in 2021, and its net foreign currency sales for the year totalled 22.7 b.kr. In April 2021, the Bank discontinued the regular currency sales programme it had begun in September 2020, as the currency market had become more balanced. The pension funds were large-scale purchasers of foreign currency, and foreign investors continued to sell domestic securities. The entry into force at mid-year of the new Foreign Exchange Act marked an important milestone, as it expanded authorisations for derivatives trading, among other provisions. The new Act abolished the last of the capital controls introduced in November 2008. At the year-end, the Bank's international reserves totalled 923.1 b.kr., or 30% of GDP.*

### **Exchange rate developments**

The króna appreciated by 2.5% in trade-weighted terms and by 5.8% against the euro in 2021. The exchange rate bottomed out in January. It rose in the first half of the year, peaking in early June, driven by foreign currency inflows in connection with tourism and with foreign investors' share purchases in Íslandsbanki's initial public offering (IPO), among other things. The króna then depreciated from early August, owing to the deteriorating outlook for tourism, increased uncertainty about the inflation outlook, capital outflows, and uncertainty during the run-up to the Parliamentary elections in September. An increase in the capelin quota was announced in October, boosting the outlook for exports, although this was offset by uncertainty about the inflation outlook and developments in the COVID-19 pandemic. The króna appreciated, however, following the Central Bank interest rate hike in November. Exchange rate volatility eased from the prior year, with the spread

between the high and low exchange rate index values measuring around 7%. The foreign exchange market was more stable than in 2020, and currency flows appeared more balanced as the year progressed. The króna appreciated the most in March (2.9%) and depreciated the most in August (2.1%).

### **Foreign exchange market**

The Central Bank's foreign exchange market transactions in 2021 were undertaken in accordance with the intervention policy laid down by the Monetary Policy Committee in May 2017, which states that the Bank will intervene in the market as it deems necessary in order to mitigate exchange rate volatility. The Bank's foreign exchange market activity during the year entailed direct intervention, regular and pre-announced currency sales, and one-off transactions mostly in connection with the Íslandsbanki IPO. The Bank both bought and sold currency during the year. Its largest single-month sales took place in January, at 14.6 b.kr. (93 million euros), and its largest single-month purchases came in June, at 18.2 b.kr. (124 million euros), the latter in connection with the aforementioned IPO.

The Bank's last market transactions for the year took place in early October. Until then, it had traded in the market each month since February 2020. In all, the Bank bought currency for 26.9 b.kr. (183 million euros) and sold currency for 49.6 b.kr. (323 million euros). Its net sales therefore totalled 22.7 b.kr. (140 million euros) during the year.

Turnover in the interbank foreign exchange market totalled 363 b.kr. (2.4 billion euros) in 2021, a reduction of 12% relative to 2020. The Bank's share in market turnover was 21%, down from 37% in 2020.

Uncertainty about the impact of the pandemic on the domestic economy continued to affect the exchange rate of the króna during the year. As vaccination rates rose and restrictions on travel were eased, the tourism industry rebounded strongly, and foreign payment card turnover in Iceland surged year-on-year. Foreign investors continued to sell domestic equity and debt securities, as they had in 2020, and this affected the exchange rate. Net capital outflows due to sales of new investments totalled 59.8 b.kr. in 2021. As before, the pension funds were active buyers of foreign currency, with net purchases totalling 54 b.kr., about the same as in 2020.

The new Foreign Exchange Act, no. 70/2021, entered into force at the end of June 2021. The Act marked a milestone, as it removed the last of the capital controls that had been imposed in November 2008. Special rules on so-called offshore krónur were repealed, and derivatives transactions involving the Icelandic króna were authorised, irrespective of their purpose.

### **International reserves**

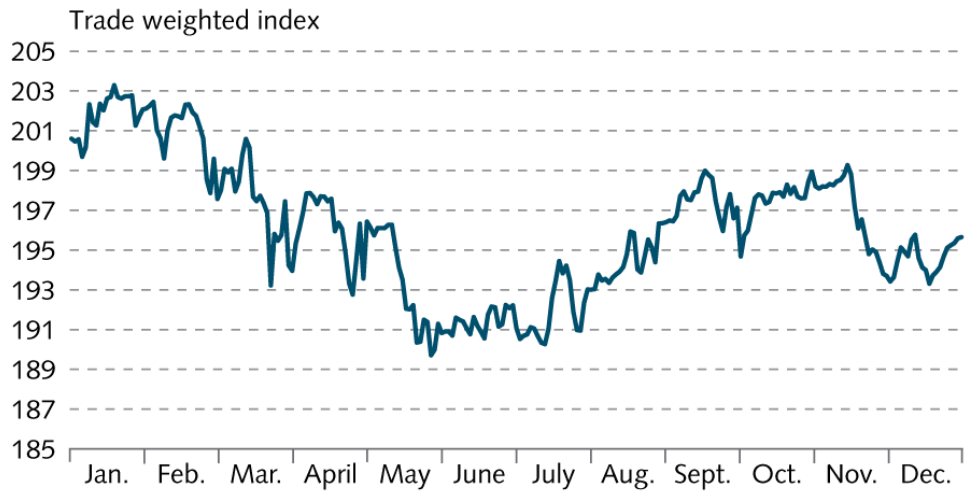
At the end of 2021, the Central Bank's international reserves amounted to 923.1 b.kr., some 106.7 b.kr. more in krónur terms than at year-end 2020. In US dollar terms, the reserves increased by 0.3 billion dollars, to a total of 7.1 billion dollars at the year-end. At that time, the reserves totalled 30% of GDP and 40% of broad money holdings (M3), and they covered ten months' worth of goods and services imports. In January, the Republic of Iceland issued a eurobond in the amount of 750 million euros, which explains in large part the increase in the reserves during the year. Furthermore, in August, the International Monetary Fund (IMF) allocated special drawing rights (SDR) to member countries, with the equivalent of 55.4 b.kr. allocated to Iceland.

Interest payments on Treasury foreign loans totalled 1.6 b.kr., and other foreign exchange transactions came to 13.1 b.kr. Interest income net of interest expense on the Central Bank's external assets and liabilities totalled 2 b.kr. Price changes in the markets reduced the international reserves by 10.4 b.kr., and exchange rate movements led to a reduction of 19.4 b.kr. At the end of 2021, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 579 b.kr., as compared with 566 b.kr. at the end of 2020.

The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 529 b.kr. at year-end 2021, as opposed to 572 b.kr. at the end of 2020.

Chart 1

## Exchange rate of the Icelandic króna 2021

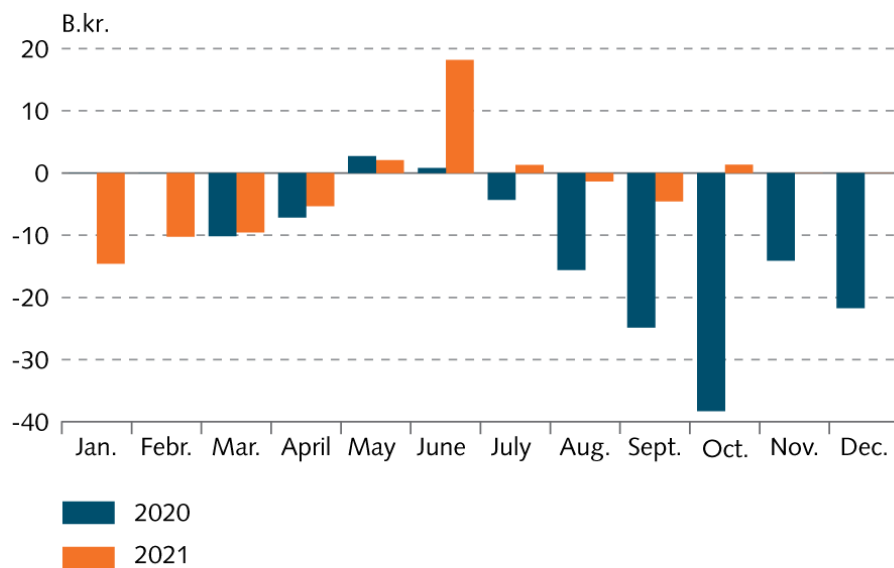


Narrow trade basket. An increase in the series indicates a depreciation and a decline indicates an appreciation.

Source: Central Bank of Iceland.

Chart 2

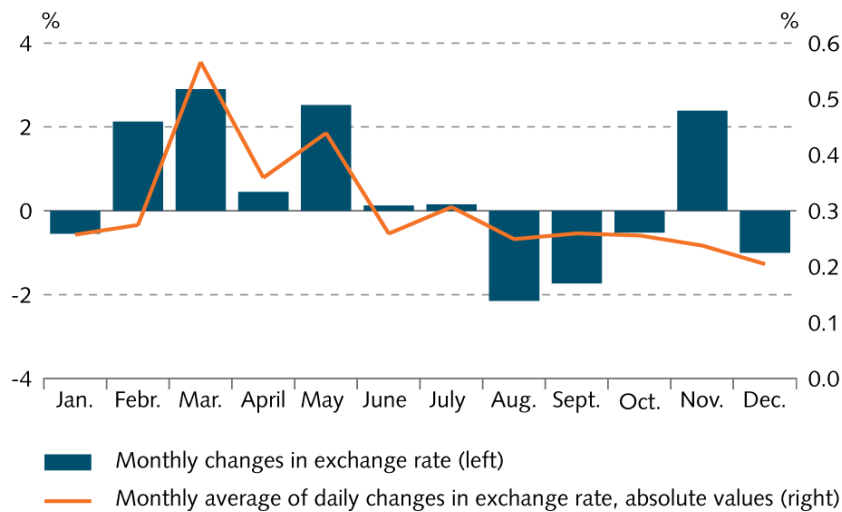
## Net Central Bank foreign exchange transactions 2020-2021



Source: Central Bank of Iceland.

Chart 3

### Exchange rate volatility 2021



Source: Central Bank of Iceland.

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

		2019	2020	2021
ISK exchange rate (-depreciation / +appreciation)	%	-3.1%	-10.4%	2.5%
Exchange rate volatility <sup>1</sup>	%	7.1%	8.5%	7.0%
FX market turnover	b.kr.	191	426	363
Central Bank share	%	7.6%	36.6%	21.1%
FX market purchases, Central Bank	b.kr.	2.4	11.7	26.9
FX market sales, Central Bank	b.kr.	11.9	144.4	49.6
Net FX transactions, Central Bank	b.kr.	-9.5	-132.7	-22.7
Reserves in USD	USD m	6,787	6,420	7,080
Reserves in b.kr.	b.kr.	822	817	923
Reserves financed domestically <sup>2</sup>	b.kr.	611	566	579
Central Bank foreign exchange balance <sup>3</sup>	b.kr.	646	572	529
Reserves, as % of GDP <sup>4</sup>	%	28%	30%	30%
Reserves, equivalent months of imports <sup>5</sup>		9	9	10

1. Standard deviation of daily exchange rate movements, annualised.

2. International 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-2021 GDP forecast.

5. Five-year average.